CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2009-II

CONTENTS

1. Overview

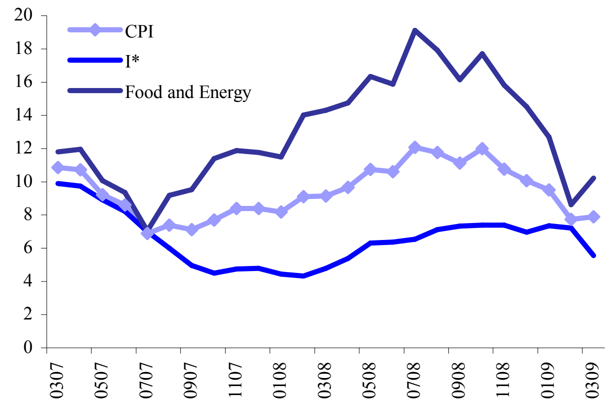
During the first quarter of 2009, the adverse feedback loop between the real and financial sectors seems to have intensified. Advanced economies have resorted to a wide range of policies including programs to deal with distressed assets along with unprecedented fiscal measures. Although these efforts have been somewhat successful in calming down the financial markets, ongoing financial strains and the deep loss of confidence have led to a significant contraction in global economic activity. Accordingly, inflationary pressures, which were perceived as a major concern until the last quarter of 2008, have been overtaken by fears of deflation in developed countries.

The contraction in global trade and financial flows have led to severe downturns in many emerging market economies, including Turkey. After having slowed down towards mid-2008, the economy is now in recession owing to negative growth rates over the last two quarters. Receding inflationary pressures have allowed the Central Bank of the Republic of Turkey (CBRT) to focus on alleviating the harsh impact of the global financial crisis on the domestic economy without endangering its main objective of price stability. In this respect, the CBRT has delivered sizeable cuts in policy rates and implemented several precautionary measures to facilitate the smooth operation of the credit and financial markets (Box.1.1).

1.1. Inflation Developments

With the intensification of the contraction in economic activity, disinflation became more evident across all major categories of the CPI basket. Energy and food inflation, as well as core inflation, have eased considerably, bringing the annual headline inflation to 7.89 percent in March―slightly above the lower bound of the uncertainty band. Moreover, the annual rate of change in the CPI measure excluding energy, food, tobacco and gold (I index) declined from 6.97 percent to 5.56 percent (Graph 1.1.1).

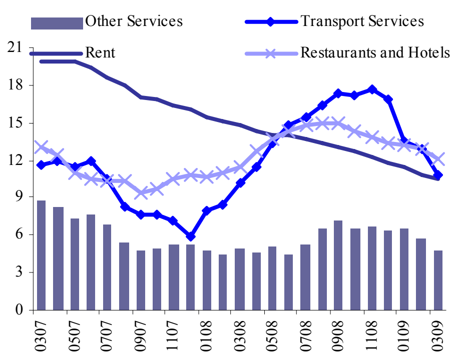
Graph 1.1.1. Developments in Inflation



* CPI excluding food, energy, alcoholic beverages, tobacco products and gold.
Source: TURKSTAT, CBRT.

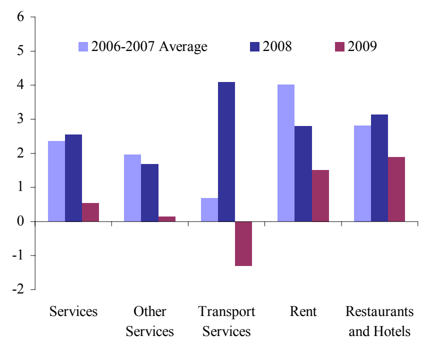
To better understand the significant downturn in the underlying trend of inflation, it is useful to focus on services prices. Services inflation, which had remained relatively elevated in the first three quarters of 2008 due to the second round effects of energy and food prices, have started to ease considerably in the last quarter of 2008 following the sharp contraction in the domestic economic activity. The deceleration in services inflation became more widespread across subgroups in the past quarter, and the cumulative rate of change in services prices during first three months of 2009 was only 0.53 percent, which historically, is the lowest reading on record (Graph 1.1.2 and Graph 1.1.3).

Graph 1.1.2. Services Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Graph 1.1.3. Services Prices
(First Quarter Percentage Change)



Source: TURKSTAT, CBRT.

The intensification of global financial market turmoil during the last quarter of 2008 has led to a wave of financial deleveraging, leading to a sharp depreciation of emerging market currencies, including the Turkish lira. In the October 2008 Inflation Report, it was indicated that the significant slowdown in domestic demand should limit exchange rate pass-through to domestic prices. In fact, the extent of exchange rate pass-through has been rather limited thus far compared to past episodes of sharp depreciations, partly owing to easing import prices.

1.2. Monetary Policy

Anticipating that substantially lower commodity prices in parallel with the significant weakening of domestic demand would decrease inflation, the Monetary Policy Committee (MPC) adopted a strategy of front-loading policy easing by cutting overnight rates by a total of 700 basis points over the past six months. The extent of policy easing was more than any other emerging market economy operating within an inflation targeting framework. Data releases since the inception of the rate cutting cycle have vindicated these preemptive monetary policy decisions, and have had a favorable impact on inflation expectations. These developments, combined with the slight reduction in global financial market stress levels, have led to a sizeable drop in the benchmark government bond rates. Moreover, the MPC stated that the easing bias might be maintained for a considerable period, which further supported the downward shift in government yields.

While the policy rate and bond yields have declined considerably, bank loan rates have not decreased in proportion. Banks have been reluctant to expand credit supply on the back of ongoing global uncertainties and contracting domestic activity. Heightened credit risk, tightening external finance conditions and the existing maturity mismatches have kept banks cautious, limiting the decline in the bank loan rates. Overall, financial conditions have remained relatively tight, notwithstanding the significant easing in monetary policy.

1.3. Inflation Outlook

The sharp contraction in global economic activity and its larger than anticipated impact on domestic activity has led to the downward revision of the outlook envisioned in the previous Report. In the January Inflation Report, output was expected to display a significant decline in the last quarter of 2008, while it was anticipated that the speed of contraction would start to loose pace during the first quarter of 2009. In line with expectations, Gross Domestic Product (GDP) displayed a sizeable drop in the last quarter of 2008 measured using seasonally adjusted growth rates, but also suffered a sharp contraction over the year as well. Furthermore, coincident indicators of economic activity suggest that the contraction in GDP during the first quarter of 2009 was significantly larger than foreseen in the previous Report. This development was the main reason underlying the downward revision in the outlook for inflation and monetary policy.

During the last quarter of 2008, the collapse of production has been disproportionately severe for export-oriented firms, and—along with increasing labor force participation rates—has brought about a surge in the unemployment rate. Moreover, recent indicators suggest that employment losses have continued during the first quarter of 2009. Therefore, labor market conditions are expected to contain unit labor costs and curb domestic demand in the period ahead.

Lower policy rates and expansionary fiscal policy are expected to provide some stimulus to the domestic demand starting from the second quarter. However, it is anticipated that it will take some time for the global economy to stabilize and thus the recovery in aggregate domestic activity will be gradual. Accordingly, aggregate demand conditions should support disinflation more forcefully and for a longer period of time than envisaged in the previous Report.

Because of the increasing share of durables and capital goods, export performance has become more sensitive to global business cycles over the past few years. As a consequence, the significant slowdown in Turkey's major trading partners and the attendant sharp contraction in exports, were among the main drivers of the abrupt downturn in the aggregate demand in the last quarter of 2008. In this context, assumptions on the likely course of the global economy remain to be of utmost importance with regard to the outlook for domestic inflation and monetary policy.

International credit markets continue to be under strain and there are no clear signs of a durable improvement in the global economic outlook. In the January Inflation Report, we assumed that the recovery in the global economy would start at the beginning of 2010. However, data releases since then have indicated a sharper contraction in 2009 and a more gradual recovery throughout 2010. Therefore, compared to the previous report, the revised forecasts are based on a deeper contraction in 2009, and a global recovery that will be visible by mid-2010, rather than at the beginning of 2010.[1]

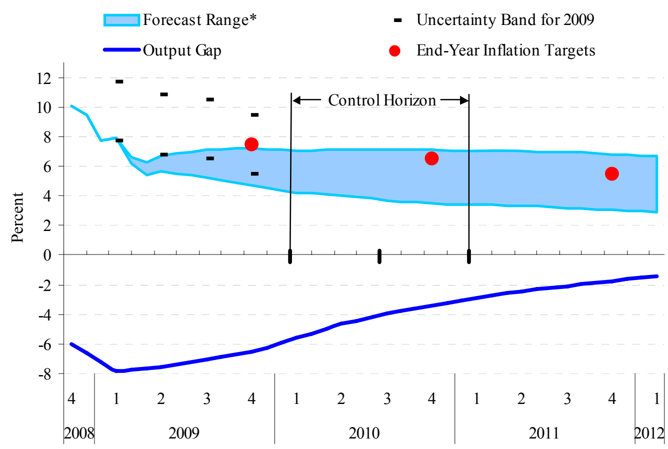
Overall, problems in the global economy and the tightness in financial conditions persist. Although domestic demand conditions are expected to begin to stabilize on the back of recent monetary accommodation and fiscal stimulus packages, an acceleration in aggregate demand is not expected anytime soon, given the depressed global economy and the associated tightness in external financing conditions. Moreover, low levels of disposable income and precautionary saving should continue to curb domestic demand, given the harsh labor market conditions. Therefore, the recovery in domestic economic activity is expected to be gradual, and inflation is expected to decline further.

Despite the downward revision in the outlook for economic activity, there have been no major developments that require revising the oil and food price assumptions stated in the past Report. Therefore the previous assumptions of oil prices at 55 USD per barrel, and food inflation of 7.5 percent for 2009 and 6 percent thereafter are maintained.

Against this background, assuming some measured easing in the short term, and constant policy rates thereafter, the medium-term forecasts suggest that, with 70 percent probability, inflation will be between 4.8 and 7.2 percent with a mid-point of 6.0 percent at the end of 2009, and between 3.5 and 7.1 percent with a mid-point of 5.3 percent at the end of 2010. Furthermore, it is expected that inflation to come down to 4.9 percent by the end of 2011 (Graph 1.3.1).

[1] The word “recovery” in this Report refers to a significantly positive growth in economic activity in year-on-year terms.

Graph 1.3.1. Inflation Forecasts*



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

To sum up, the sharp weakening in aggregate demand has not only led to a faster-than-envisaged rate cuts, but has also required a downward revision in the medium-term forecasts. The revised forecast suggests that the recent rate cuts have lowered the probability of significantly undershooting the end-year inflation target (Box 2.1). However, given the tightness in financial conditions and ongoing uncertainties regarding the timing of the recovery in the global economy, it may be necessary for the monetary policy to maintain an easing bias for a considerable period.

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 CBRT.

1.4. Risks

Given that global economic conditions have a significant effect on the Turkish economy both through finance and trade linkages, the outlook for global economy remains a key input for the medium-term forecasts. In the January Inflation Report, medium-term forecasts included three scenarios: (i) baseline, (ii) early recovery, and (iii) late recovery. In this Report, the "early recovery" scenario (with recovery starting in the third quarter) was dropped because global economic growth forecasts were continuously revised downward over last three months.

Therefore, the final chapter of the Report contains only one alternative scenario which is contrasted against the baseline. In the alternative scenario, it is assumed that the recovery in the global activity will start at the beginning of 2011. This case corresponds to weak external demand and tighter credit conditions for an extended period, along with suppressed commodity prices throughout the forecast horizon. Under this scenario, the projections suggest that medium-term inflation targets could be undershot even with a sequence of measured policy rate cuts throughout 2009.

The stance of fiscal policy is another major factor that may affect the outlook for inflation and monetary policy. Recently, budget revenues have been declining in line with the slowdown in economic activity, while expenditures have been accelerating due to countercyclical fiscal policy, leading to a significant rise in the budget deficit. Possible adjustments in excise taxes and/or administered prices in order to stabilize the budget could result some inflation volatility over the short term. Moreover, the increasing financing requirement of the government might weaken the favorable impact of monetary policy decisions on economic activity. Therefore, in order to reap the gains from short-term expansionary fiscal policy, it is important to commit to a credible medium-term fiscal framework that would ensure fiscal discipline and debt sustainability.

The CBRT 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. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global crisis. Therefore, strengthening the commitment to fiscal discipline and the structural reform agenda is also critical for facilitating expectations management and for supporting the effectiveness of the monetary policy decisions. In this respect, commitment to the European Union accession process, and timely implementation of the structural reforms envisaged in the Pre-Accession Economic Program remain to be of utmost importance.

Box 1.1 MEASURES TAKEN BY THE CENTRAL BANK OF THE REPUBLIC OF TURKEY TO REDUCE THE IMPACT OF THE GLOBAL CRISIS

The Central Bank of the Republic of Turkey has adopted a series of measures to maintain confidence and economic and financial stability in Turkey against the global financial crisis that has deepened and broadened further since mid-2008. Key measures are briefly as follows:

Policy rate decisions: The global financial crisis spiraled into a deep recession starting from the fourth quarter of 2008, leading to sharp economic contraction and a steep decline in commodity prices. These developments had signaled a solid downward move in inflation. With the relatively stronger financial structure and less deteriorated risk premium in Turkey, the Bank has been able to cut policy rates at a dramatic pace to mitigate the economic contraction and to avoid severe downward deviations from inflation targets. Accordingly, the Bank cut policy rates by a total of 700 basis points in 6 months from November 2008 to April 2009.

Measures regarding Turkish lira liquidity: Since May 2008, the Bank provides liquidity through regular 1-week repo auctions in cases of liquidity shortages in the market and keeps overnight market rates close to its borrowing rate.

The Bank rearranged the methods of using the Liquidity Support Facility on January 29, 2009. Article 40 of the CBRT Law states that "The Bank may extend credits to the banks that are the subject of uncertainty and lack of confidence in the event of acceleration of fund withdrawals and uncertainty and lack of confidence in the banking system, in the amount to cover the withdrawal of funds, the conditions of which shall be determined by the Bank". The terms and conditions for such credits were laid down in the Liquidity Support Facility Regulation and announced on CBRT's website. According to the regulation, the credits are available, in cases of emergency, as advance payments, with one month maturities, for a maximum period of one year, at CBRT's interbank lending rate, limited to the amount twice as much as the equity capital of the applying bank. Yet, there has been no need to resort to this tool, thanks to the soundness of the banking system and its resistance against any external shocks, and CBRT's resilient and effective liquidity management.

Measures regarding foreign exchange liquidity: The Bank took further measures to enhance the orderly functioning of the foreign exchange market and to boost foreign exchange liquidity, such as:

- On October 9, 2008, the Bank resumed its intermediation role in its Foreign Exchange Deposit Market within the Central Bank, revised interbank transaction limits based on the size of banks' balance sheets on October 14, 2008, and doubled transaction limits up to a sizable 10.8 billion US dollars on October 24, 2008.
- On October 16, 2008, the Bank suspended foreign exchange buying auctions, which had been in place to strengthen foreign exchange reserves since 2002, and kept the liquidity that had been drained from the foreign exchange market in the system.
- On October 24, 2008, the Bank resumed foreign exchange selling auctions and set the daily selling amount at 50 million US dollars. However, on October 30, the Bank suspended foreign exchange selling auctions on improved conditions in global financial markets. In the meantime, the Bank conducted two auctions and sold a total of 100 million US dollars. In the face of noncompetitive pricing in the foreign exchange market, the Bank resumed foreign exchange selling auctions again on March 10, 2009, and sold a total of 900 million US dollars in 18 auctions until April 3, 2009 when auctions were suspended again.
- On November 21, the Bank lengthened the maturity of the FX deposits in terms of US dollar and Euro borrowed by the banks from foreign exchange deposit markets from 1 week to 1 month, and reduced the lending rates from 10 percent to 7 percent for US dollar and to 9 percent for Euro. In view of the developments with regard to interest rates in the international money markets, on February 20, 2009, the Bank lengthened the maturity of foreign exchange deposits borrowed by the banks to 3 months, and cut lending rates for transactions which the Central Bank is a party to 5.5 percent for US dollar and to 6.5 percent for Euro. Moreover, the Bank lengthened the maturity of matched interbank transactions in the said market from a maximum of 1 month to 3 months.
- On December 5, 2008, the Bank reduced the foreign exchange required reserve ratio by 2 points from 11 to 9 percent, and injected an additional foreign currency liquidity that is equivalent to approximately USD 2.5 billion to the banking system. The Bank also canceled the interest payments on foreign exchange reserve requirements and raised the interest rate on Turkish lira reserve requirements to promote de-dollarization and boost Turkish lira deposits and loans.

Measures regarding the real sector: In order to alleviate the impact of the global crisis on the corporate sector, the Bank rearranged export rediscount credits:

- On December 5, 2008, the Bank raised pre- and post-shipment export rediscount credit limits by 500 million US dollars to 1 billion US dollars, rearranged the methods of using export rediscount credits and provided easy access to these credits. On April 17, 2009, the Bank raised export rediscount credit limits to 2.5 billion US dollars.

- On March 20, 2009, in order to widen the use of export rediscount credits and facilitate access to more companies, the Bank extended the pre-shipment financing facility, along with exporters and manufacturer-exporters, to manufacturers who manufacture final products for export purposes and export them via exporters but do not qualify as an export company. In addition, the Bank raised the credit limit of 10 million US dollars per company to 40 million US dollars for Foreign Trade Capital Companies. On April 17, 2009, the Bank raised the credit limit of 10 million US dollars per company excluding foreign trade capital companies to 20 million US dollars.

Accordingly ,these arrangements caused CBRT/Turkish Eximbank export rediscount credits extended via Turkish Eximbank to increase sharply, from 1.7 million US dollars in 2008 as a whole to 547.6 million US dollars between January 1 and April 29, 2009.

Box 1.2 THE FRONT-LOADED MONETARY POLICY SINCE NOVEMBER 2008 AND ITS EFFECTS

With the deepening of the global crisis since the fourth quarter of 2008, the CBRT has cut policy rates at a more rapid and aggressive pace, compared to the mostly cited “measured and gradual easing cycle”. To help gain a better understanding, this Box gives a brief account of the policy decisions after 2006 and analyzes the effects of the front-loaded monetary policy that has been conducted since the fourth quarter of 2008.

Why do central banks adopt measured and gradual changes in policy rates?

Central banks often adopt a monetary policy that seeks measured and gradual changes in policy rates. In the economic literature, this behavior is explained by (i) uncertainties, which policy-makers face, (ii) concerns over expectation management, and (iii) worries about reducing the risks to financial stability.

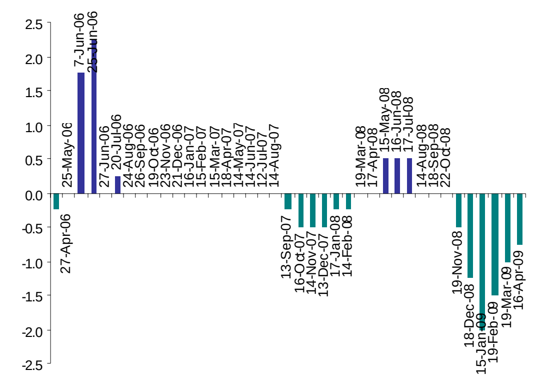
Uncertainties over economic analyses and forecasts are the key elements that cause policy-makers to act prudently. One of the most common uncertainties that central banks face is the uncertainty surrounding the basic parameters of the monetary transmission mechanism. Referred to as the Brainard uncertainty in the literature, this uncertainty prompts policy-makers to adjust policy rates in small steps and gradually, if they have concerns about the outcome of their decisions. Another uncertainty policy-makers encounter is the delay on the release of economic data and the lack of precise information about the present and future stance of the economy due to measurement errors.

One of the main reasons why central banks generally choose to cut policy rates gradually and by very little is the key role of this behavior in setting long-term interest rates. Central Banks are unable to directly set long-term interest rates, but have a partial impact on medium- to long-term interest rates by disclosing future policy rates through effective and transparent communication. As long-term interest rates are shaped by expectations for short-term interest rates, central banks disclose future policy rates by changing short-term interest rates gradually and in measured steps, strengthening their control over long-term interest rates.

A faster-than-expected, surprisingly aggressive reduction in short-term interest rates may induce speculative activity in financial markets and impair their orderly functioning. Therefore, measured and gradual changes in policy rates are influenced by the concerns about financial stability.

CBRT and Policy Rates

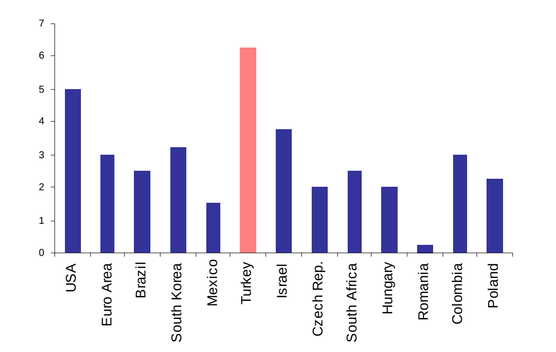
Graph 1. CBRT Policy Rate Decisions during Inflation Targeting



Source: CBRT.

In Turkey, since the onset of inflation targeting in 2006, the CBRT announced forty-two policy decisions, nineteen of which involved a policy rate change. Twelve of them amounted to 0.50 basis points at most. As shown in Graph 1, the Bank had embarked on two monetary easing cycles during inflation targeting. Between September 2007 and February 2008, the Bank cut rates gradually and in measured steps, by a total of 225 basis points in 6 months.

Graph 2. Cumulative Central Bank Rate Cuts since the Deepening of the Crisis*



*The spread between policy rates from the date each central bank started to cut rates to end-March 2009.
Source: Bloomberg.

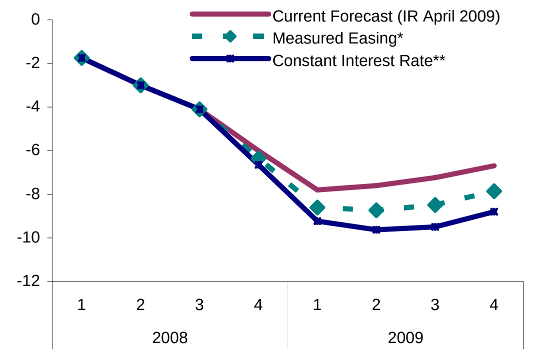
Although central banks commonly choose a measured and gradual monetary policy, the recently ongoing global crisis, the resulting sharp financial contraction and the heightened risk of a deeper recession mark the current period as extraordinary and require a more unconventional perspective on recent monetary policy implementations. In fact, as shown in Graph 2, since the deepening of the global crisis towards the end of

2008, most central banks suspended the traditional measured monetary easing and embarked on an aggressive one.

What would have happened if the Bank hadn't lowered policy rates aggressively?

To better understand the recent monetary policy strategy, we should ask "What would have happened if the Bank had maintained another monetary policy instead of the front-loaded, which has been in place since November 2008". To this end, we developed two projections for economic activity and inflation, based on two alternative policy actions. In the first scenario, policy rates are assumed to have been lowered by 50 basis points each month since November 2008, while in the second scenario, policy rates are assumed to have remained unchanged. Projections based on these scenarios are shown in Graph 3 and Graph 4.

Graph 3. The Impact of Front-Laoded Monetary Easing on Output Gap

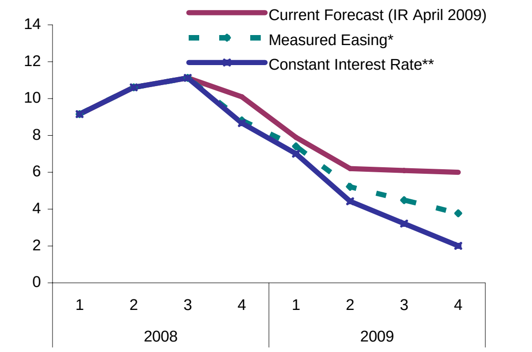


* If policy rates had been lowered by 50 basis points every month after November 2008.
** If policy rates had remained unchanged after November 2008.
Source: CBRT

Accordingly, if the Bank had lowered policy rates by a measured 50 basis points each month since November 2008, instead of an aggressive 700 basis points, the end-2009 growth forecasts would have been revised down by around 2.4 percentage points.

Moreover, the measured monetary easing since November 2008 appears to have an upward pressure of 2.2 percentage points on the end-2009 inflation forecasts (Graph 4). In other words, if the Bank had lowered policy rates by a total of 300 basis points since November 2008, instead of an aggressive 700 basis points, the end-2009 inflation forecast would have been revised down from 6 percent to 3.8 percent, significantly undershooting the 7.5 percent year-end target. Thus, the recent front-loaded monetary easing has not only alleviated the sharp contraction in economic growth

Graph 4. The Impact of Front-Laoded Monetary Easing on Inflation



* If policy rates had been lowered by 50 basis points every month after November 2008.
** If policy rates had remained unchanged after November 2008.
Source: TURKSTAT, CBRT.

and dampened the spillovers from the global crisis but also helped prevent the significant undershoot of the end-2009 inflation target. Moreover, the Bank previously announced that a significant undershoot of the end-2009 inflation target was not desirable under current economic conditions.

Meanwhile, the answer to the question of "What would have happened if the Bank had left policy rates unchanged since November 2008" produces more striking results. If policy rates had been left unchanged, the end-2009 inflation forecast would have been revised down by 4 percentage points, and the economic contraction would have been 4.3 percentage points sharper than it is now.

Article 4 of the CBRT Law stipulates that "The Bank shall, provided that it shall not be in confliction with the objective of achieving and maintaining price stability, support the growth and employment policies of the Government". This statement was developed to address problems in such hard times. In view of the above results, the front-loaded monetary policy seems to help mitigate the severity of violent turbulences in the economy during such a sharp economic downturn. The monetary tightening to cushion price stability against economic overheating and the aggressive monetary easing during severe economic slowdown, without prejudice to the objective of price stability, help reduce the severity of unwanted volatilities and restore economic growth to the long-run level. CBRT's monetary easing cycle since November 2008 should be evaluated in view of the above considerations.

2. International Economic Developments

The effect of the global financial crisis on the world economy has been more severe since the final quarter of 2008. Advanced economies expanded their liquidity injection and bailout plans to include a broader range of distressed assets in the fourth quarter and enacted the largest fiscal stimulus packages in history. However, despite all these measures, the further sharp tightening of financial conditions and the loss of confidence triggered by the global crisis led to a marked decline in growth rates amid the reduced global economic activity. In this period, world GDP slowed sharply, industrial production registered the steepest contraction since WWII, unemployment climbed dramatically, and household and business confidence indexes sunk to historic lows.

Leading indicators and confidence indices continued to plunge in the first quarter as credit availability tightened significantly. Although there has been some improvement in expectations recently, the uncertainty remains about when the global economy will start to recover.

Given the rapidly changing economic outlook, international institutions revise their global growth forecasts more frequently. Revisions continued to be downward in the first quarter, signaling that the economy might recover much later than predicted in the January Inflation Report (Box 2.1).

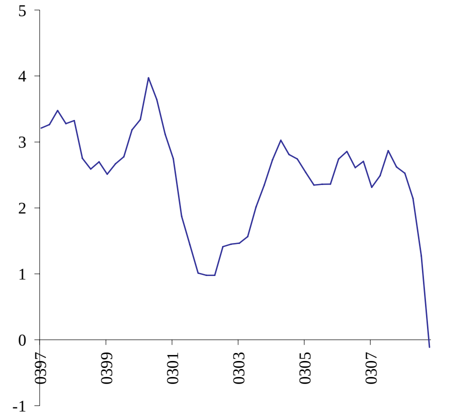
In addition to the measures taken by individual countries to address the global crisis, world's major economies decided at the G-20 summit in London in March to approve coordinated and joint actions to stimulate the global economy. The G-20 is particularly important because of the injection of massive funds into the world economy and the decisive and coordinated action to tackle the financial crisis. Participants decided to raise 1.1 trillion US dollars for IMF and agreed on a fiscal stimulus package of about 5 trillion US dollars for member states. Although no specific target was laid out at the summit for the strict auditing of the financial sector, the particular mention of auditing translates into a more stable post-crisis financial system.

Although G-20 actions to expand stimulus packages and raise IMF funds may help to bring forward the global economic recovery, there are certain risks that might delay the recovery of the world economy. Foremost, the massive contraction in real economies jeopardizes the structure of financial institutions that has already weakened, and therefore the cycle of real vs. financial sector deepens further. Currently, monetary policy in emerging economies has lost much of its short-term interest rate elasticity against the economic meltdown, while policy rates in some countries fell close to the zero bound. Thus, as another significant risk factor, the deflation risk in advanced economies is expected to intensify and delay spending in coming months and cause economic recession to deepen.

2.1. Global Growth

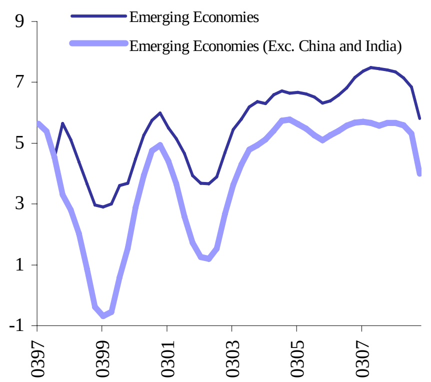
The annual composite GDP growth[1] in advanced economies fell from 1.3 percent in the third quarter of 2008 to –0.1 percent in the fourth. The US performed the worst, contracting to –0.8 percent, while the GDP in the euro area and Japan dropped to 0.6 and –0.7 percent, respectively (Graph 2.1.1).

Graph 2.1.1. Growth Rate in Advanced Economies
(Percent)



Source: Bloomberg, CBRT.

Graph 2.1.2. Growth Rate in Emerging Economies (EE)
(Percent)



Source: Bloomberg, CBRT.

The US economy posted an annualized quarterly growth rate of –6.3 percent in the final quarter of 2008, the sharpest contraction since the first quarter of 1982. The biggest contribution to the 6.3 percent contraction resulted from falling investments with 3.5 percentage points, 0.8 percentage points of which were from housing starts. Consumption spending, accounting for about 70 percent of the US GDP, fell by 4.3 percent, making a negative contribution of 3.0 percentage points to growth. The only positive contribution to the US economy came from government spending with 0.3 percentage points.

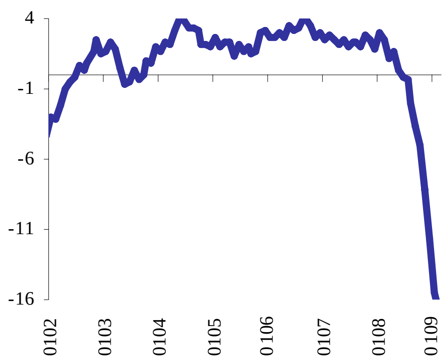
[1] Growth rates are derived from 4-quarterly cumulative national income figures.

Meanwhile, the euro area economy shrank by a quarterly 1.6 percent with contributions from consumption spending, –0.2 percentage points, investments, –0.6 percentage points, and government spending, 0.1 percentage points.

The growth rates in emerging economies also fell markedly. The annual composite GDP growth in emerging economies dropped from 6.8 percent in the third quarter to 5.8 percent in the fourth quarter, but excluding China and India, it went down from 5.3 to 4.0 percent (Graph 2.1.2).

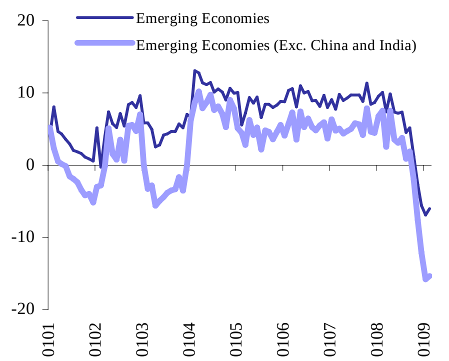
Industrial production continued to plunge year-on-year in both advanced and emerging economies during the first two months of 2009. The composite industrial production index for advanced economies dropped by 11.6 and 16.8 percent year-on-year in December and February, respectively (Graph 2.1.3). The index was particularly weak in Japan, down by a record 37.7 percent year-on-year as of February. Similarly, the index for emerging economies fell by 5.6 and 6.0 percent in the respective months. However, excluding China and India, the annual rate of decline in emerging economies increases from 12.1 to 15.3 percent (Graph 2.1.4). Having announced a fiscal stimulus package of around 600 billion US dollars in the last months of 2008, China was driven by different dynamics as compared with other countries, and industrial production growth in China rose to 11.0 percent in February from 5.7 percent at end-2008. The performance of industrial production during the first two months of 2009 suggests that first-quarter growth figures will most likely remain close to the levels in the final quarter of 2008.

Graph 2.1.3. Industrial Production Index in Advanced Economies
(Annual Percentage Change)



Source: Bloomberg.

Graph 2.1.4. Industrial Production Index in Emerging Economies
(Annual Percentage Change)

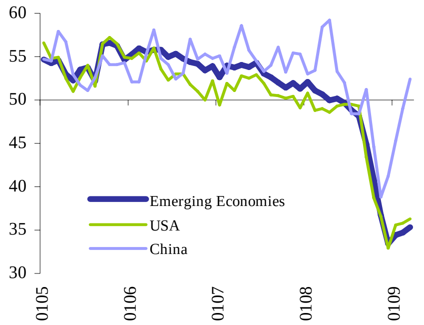


Source: Bloomberg.

After a steady slump since June 2008, the composite Purchasing Managers Index (PMI) for advanced economies is on a slight rebound since January 2009. The Index went up to 35.3 points in March from 33.4 points in December. Yet, the index was still below the neutral mark of 50 points. Meanwhile, the US PMI climbed to 36.3 points in March, up from 32.4 points in December, while the Chinese PMI rose to a record 52.4 points in March, surpassing the neutral mark of 50 points (Graph 2.1.5).

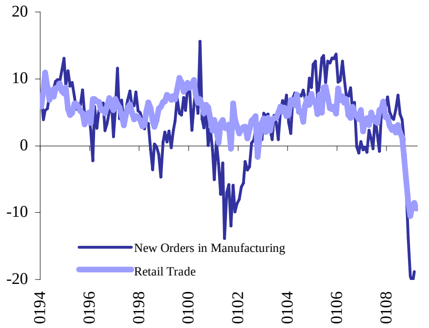
Having fallen steadily month-on-month in the second half of 2008, the retail trade volume in the US recovered slightly in January 2009, but slowed again in the following two months. After having shrunk by an average of 7.1 percent in the fourth quarter of 2008, the retail trade volume declined by only 1.3 percent in the first quarter of 2009, which indicates that consumption spending is likely to have a less dampening effect on GDP in the first quarter of 2009, offsetting the 3.0 percentage point negative contribution in the last quarter of 2008. Moreover, new orders in manufacturing rallied in February 2009 after a steady month-on-month decline since August 2008, and the acceleration in the annual rate of decline lost momentum (Graph 2.1.6).

Graph 2.1.5. PMI Indices
(Level)



Source: Bloomberg.

Graph 2.1.6. New Orders in Manufacturing and Retail Trade Volume in the US
(Annual Percentage Change)



Source: Bloomberg.

The global crisis has major effects on job markets and causes social costs to rise. In the US, unemployment climbed to 8.5 percent in March 2009 from 5.1 percent a year ago in seasonally adjusted terms. In the euro area, unemployment soared to 8.5 percent in February 2009 from 7.2 percent a year earlier. Unemployment in emerging economies followed the same pattern as in the industrialized countries.

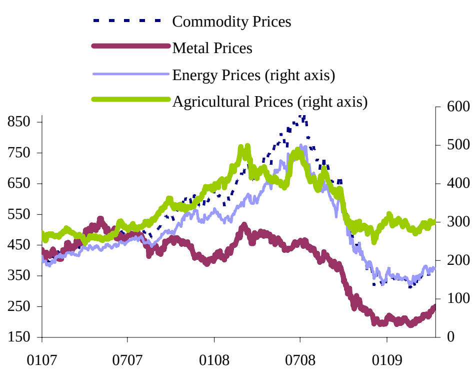
The analyzed data suggest that the first-quarter US GDP will remain on a par with the previous quarter, but with the modest rebound in consumption spending, GDP may contract at a slightly less rapid rate. Meanwhile, government spending is expected to accelerate starting from the second quarter, which is likely to make a positive contribution to growth in the following periods. The US Congressional Budget Office expects the budget deficit to total 1.9 trillion US dollars in 2009, 13.1 percent of GDP 2009, up from 5.8 percent in 2008. Due to the seeming delay in launching the necessary measures, the euro area economy is expected to recover more slowly and slightly. For an export-driven economy, it will take some time for Japan to enjoy positive growth again. In emerging economies, a breakthrough is not expected in the near term unless there is a marked acceleration in world trade volume and global capital flows.

In view of all these developments, we built our medium-term forecasts in the final chapter of this Report on the assumption that the world economy will start to recover by mid-2010.

2.2. Commodity Prices

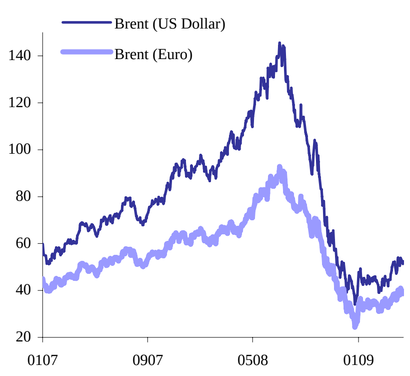
Commodity prices slumped dramatically in the final quarter of 2008 due to the marked slowdown in global economic activity, and remained relatively unchanged from their end-2008 level in the first quarter of 2009 (Graph 2.2.1). The S&P Goldman Sachs (GS) Commodity Index was down 46.4 percent year-on-year and up 2.7 percent quarter-on-quarter in the first quarter of 2009. The GS energy and metals indices increased by 4.1 and 7.7 percent, respectively, while the GS agriculture index dropped by 4.2 percent from a quarter earlier.

Graph 2.2.1. S&P Goldman Sachs Commodity Indices



Source: Goldman Sachs.

Graph 2.2.2 Crude Oil (Brent) Prices
(US dollar/bbl)

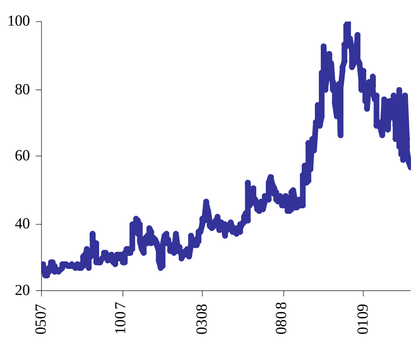


Source: Bloomberg.

After a steep decline in the fourth quarter of 2008, energy and metal prices picked up slightly in the first quarter of 2009, whereas agricultural prices continued to fall, albeit at a slower pace. Metal prices surged on increased demand from China, where an inventory build-up is in progress amid falling international prices; yet, this rally cannot be sustained as long as global demand remains weak. In addition, prices for agricultural products rose rapidly amid drops in stockpiles driven by increased grain-based biofuel production and crop losses, but do not seem to reaccelerate given the sluggish global demand and improving supply conditions.

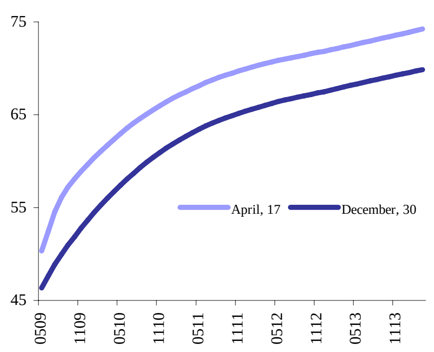
After hitting a record-high of 145.7 US dollar per barrel in July 2008, international Brent crude oil prices tumbled towards the end of the year amid reduced global demand, particularly from industrialized countries, and dipped to as low as 34 US dollar per barrel on December 24, 2008 (Graph 2.2.2). In view of the steep drop in oil prices, OPEC members decided to cut supply at meetings in September and December 2008. OPEC's output slash restored balance between supply and demand by end-2008 and kept oil prices stable at around 40-50 US dollars per barrel in the first quarter of 2009. In this period, oil prices reached an average of 45 US dollars per barrel and went down by 51.3 percent from a year earlier. At its prescheduled meeting in March, OPEC reviewed global demand conditions and decided to hold off from a further output cut and raise the rate of compliance to the cuts in previous meetings, which was 80 percent.

Graph 2.2.3. Crude Oil Volatility Index (OVX)



Source: Bloomberg.

Graph 2.2.4. Yield Curves for NYMEX (WTI) Crude Oil Futures (US dollar/bbl)



Source: Bloomberg.

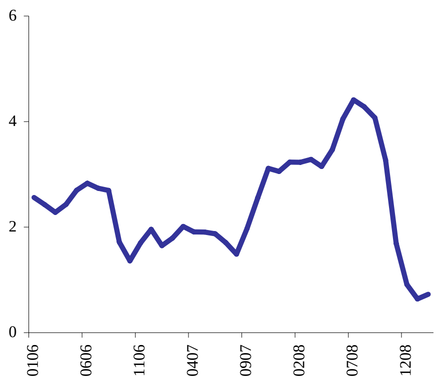
Despite production cutbacks, rising inventories put pressure on spot prices. Yield curves for crude oil shifted upwards in a month owing to the various fiscal stimulus packages launched by advanced economies and the increase in IMF funds, whereas both the subdued rise in the short end and the decline in the volatility index indicate that oil prices are increasingly unlikely to rise sharply in 2009 unless there is a serious supply shock (Graph 2.2.3, Graph 2.2.4). Yet, OPEC’s output cut strategy in the face of prices dipping below a certain level keeps prices from falling further. Thus, our medium-term forecasts in the final chapter of this Report are based on the assumption that oil prices will average 55 US dollar per barrel, as in the January Inflation Report.

2.3. Global Inflation

The economic recession spreads across the globe, particularly in developed countries, and international commodity prices fall, causing global inflation to slump. The downtrend in CPI inflation has recently intensified both in advanced and emerging economies.

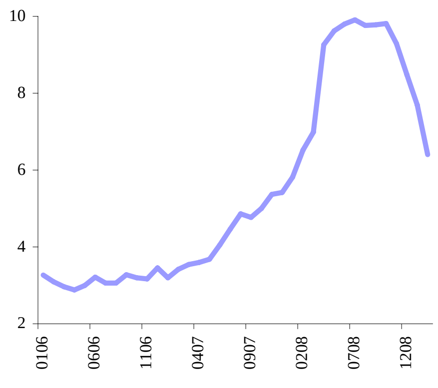
The annual CPI inflation in advanced economies dropped to 0.7 percent in February 2009, from 4.4 percent in July 2008. Similarly, the annual CPI inflation in emerging economies fell to 6.4 percent from 9.9 percent (Graph 2.3.1 and Graph 2.3.2).

Graph 2.3.1. CPI Inflation in Advanced Economies
(Annual Percentage Change)



Source: Bloomberg, CBRT.

Graph 2.3.2. CPI Inflation in Emerging Economies
(Annual Percentage Change)



Source: Bloomberg, CBRT.

Broken down by countries, inflation in Japan went down from 2.3 percent in July 2008 to –0.1 percent in February 2009. Likewise, the euro area Harmonized Index of Consumer Prices (HICP) inflation dropped to 1.2 from 4 percent. The US inflation fell from 5.4 to 0.1 percent, and sunk further in March to –0.4 percent, turning negative for the first time in nearly 50 years. In

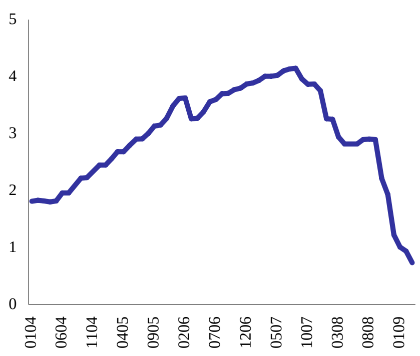
China, an emerging economy, annual inflation dropped to –1.6 percent in February from 8.7 percent a year ago.

The sharp economic slowdown and falling commodity prices cause inflation to plunge across the world, while the risk of deflation, particularly in some developed countries, has greatly increased.

2.4. Monetary Policy Developments in the World

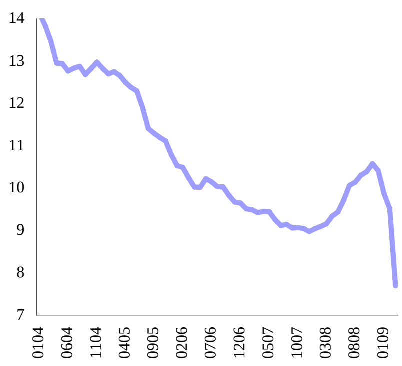
With the sharp contraction in economic activity in advanced economies and lower commodity prices, inflation rates continued to fall in the first quarter of 2009, leading to further monetary loosening, which started in mid-2008, in those countries (Graph 2.4.1).

Graph 2.4.1. Policy Rate in Advanced Economies



Source: Bloomberg, CBRT calculations.

Graph 2.4.2. Policy Rate in Inflation -Targeting Emerging Economies



Source: Bloomberg, CBRT calculations.

In addition to various standard monetary measures, such as policy rate cuts, advanced countries adopted, as a coordinated action, other non-conventional (quantitative) monetary measures that include liquidity injections into the economy and provide rapid expansion of central bank balance sheets: the Fed has strengthened and raised the limits of its expansionary monetary policy, which allows liquidity pumps into markets and rapid monetary base growth since September 2008. Accordingly, the Fed announced a new program to purchase long-term government bonds and more mortgage-backed securities, in order to help ensure the smooth functioning of the financial system and foster economic recovery. The Bank of Japan (BoJ) purchases more government bonds through open market transactions, and lately purchases corporate bonds, to ease the liquidity shortage in credit markets. Similarly, the Bank of England (BoE) started a quantitative expansion program in March that involves the purchases of corporate and government bonds. Meanwhile, the European Central Bank (ECB) had adopted a cautious attitude towards the quantitative monetary expansion, but signaled that it might resort to quantitative easing in coming months. Moreover, the Swiss National Bank's exchange market intervention to weaken the Swiss franc was one of the highlights of the first quarter.

On the emerging economies front, the monetary easing that began towards the end of 2008 became more aggressive in the first quarter of 2009. Due to reduced credit availability, resulting from the global financial turmoil, emerging economies had adopted a prudent monetary policy for fear of massive capital outflow and depreciation in local currency, but are now slashing key interest rates since December (Graph 2.4.2). 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. Moreover, since global capital flows were dominated by investors' risk appetite rather than interest rate differentials, rate cuts were more aggressive in countries where the risk premium increase was relatively more moderate (Box 5.1).

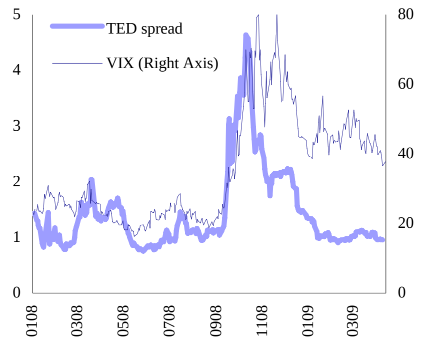
2.5. Global Risk Indicators

The risk sentiment in global financial markets have improved slightly, as compared to end-2008, owing to measures to enhance the smooth functioning of financial markets in the world, non-conventional expansionary monetary policy actions of central banks in advanced economies, and relatively improved US economy. However, the ongoing presence of downside risks to global growth, albeit to a lesser extent than in the end of 2008, the continued distress in the US housing market, and the resulting instability in prices for structured products that still appear on banks' balance sheets despite all efforts continue to pose a threat to financial stability.

Risk appetite indicators point to a some increase in future global investor risk sentiment. The VIX index has fallen modestly, suggesting that risk appetite has partly improved, compared to the fourth quarter of 2008 (Graph 2.5.1). The Credit Suisse Global Risk Appetite Index also followed the same pattern. Especially in recent months, with the stock market corrections in advanced and emerging economies, risk appetite has bounced back to "normal" territory after a long period of time (Graph 2.5.3). Moreover, TED Spread, a key indicator of liquidity shortage in interbank money markets, has narrowed significantly since its peak in October 2008 (Graph 2.5.1). Yet, the confidence erosion driven by the credit crisis prompted major commercial banks to hold more liquid assets, which caused interbank rates to remain higher than their pre-crisis level. Meanwhile, the iTraxx Europe and CDSIG indices, which are composed of the most liquid Credit Default Swap (CDS) referencing investment-grade credits in advanced economies, remained volatile on companies' profit and loss accounts in the first quarter of 2009 (Graph 2.5.2).

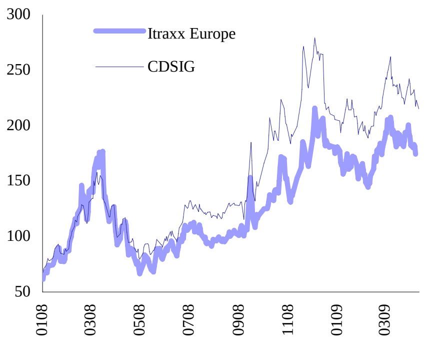
Another major highlight from the previous period is the relative improvement in key measures of investor sentiment towards emerging markets, unlike previous crisis episodes. Accordingly, although the iTraxx Crossover[2] index remained elevated, the EMBI+ index fell, albeit only slightly, in the first quarter of 2009 (Graph 2.5.2).

Graph 2.5.1. Global Risk Indicators
(TED Spread* and VIX**)



* A marker of investor confidence, calculated as the gap between 3-month LIBOR and the 3-month US Treasury bill rate.
** The VIX volatility index is based on S&P500 options and shows the market's expectation of 30-day volatility.
Source: Bloomberg.

Graph 2.5.2. Global Risk Indicators
(iTraxx Europe* and CDSIG**)



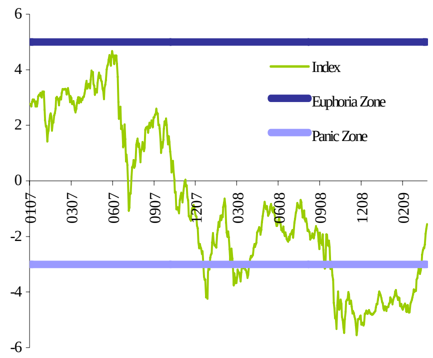
* Composed of most liquid European investment grade Credit Default Swap entities.
** Composed of most liquid US investment grade Credit Default Swap entities.
Source: Bloomberg, Markit.

Yet, developments in emerging markets differ from region to region. In early 2009, loss announcements from banks and weakening macroeconomic indicators in Central and Eastern European countries had a negative impact on the risk sentiment in some Western European countries (particularly Austria) that are heavily engaged in Central and Eastern European markets. On the other hand, with improved macroeconomic indicators, financial markets in many East

[2] 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.

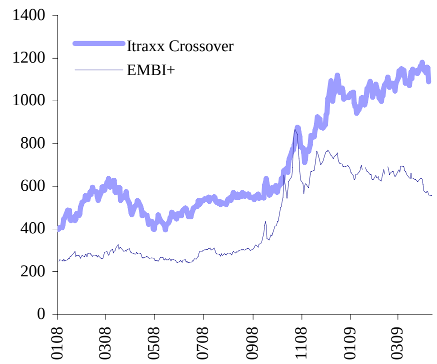
Asian countries, particularly China, performed better than other emerging market economies.

Graph 2.5.3. Credit Suisse Global Risk Appetite Index



Source: Credit Suisse.

Graph 2.5.4. EMBI+ and iTraxx Crossover *



* The iTraxx Crossover index is composed of 45 sub-investment grade credits.
Source: Bloomberg, Markit.

In sum, there has been some recovery in financial markets, compared to end-2008. Although financial markets seem to have settled down a bit since September 2008, when the global crisis peaked, they still have not gone back to normal. Thus, uncertainties about global growth and housing markets pose the greatest risk to financial market stability in the upcoming period. Although many emerging economies were performed much better in the first quarter than in previous crisis episodes, the ongoing tightening in global capital flows and credit conditions increases the risks to emerging financial markets.

Box 2.1 EXPECTATIONS ABOUT GLOBAL ECONOMY

In the previous period, the global crisis had a growing impact on real economy and the world economy contracted sharply. Due to the ongoing uncertainty about global economy, assumptions over the timing and scale of the global economic rebound are highly important for the inflation and monetary policy outlook presented in this Report. This box provides a brief account of global growth forecasts of selected international institutions. These expectations provide major input to our medium-term projections in the final chapter of the Report.

With the deepening of the global downturn in the previous quarter, many international institutions revised their global growth forecasts sharply downward for 2009 and 2010. In its World Economic Outlook April 2009 issue, the IMF slashed its 2009 forecast for world growth from 0.5 percent in January to –1.3 percent (Table 1). Similarly, Consensus Economics cut its global growth forecast for 2009 to –2.1 percent in April from 0.5 percent in December. Meanwhile, the OECD cut its US and Euro area growth for 2009 from –0.9 and –0.6 percent to –4 and –4.1 percent, respectively.

Table 1. Annual Growth Forecasts

	2009		2010	
	Previous	**Revised**	**Previous**	**Revised**
IMF				
World	0.5	-1.3	3.0	1.9
Advanced Economies	-2.0	-3.8	1.1	0.0
USA	-1.6	-2.8	1.6	0.0
Euro area	-2.0	-4.2	0.2	-0.4
Emerging Economies	3.3	1.6	5.0	4.0
OECD				
All OECD	-0.4	-4.3	1.5	-0.1
USA	-0.9	-4.0	1.6	0.0
Euro area	-0.6	-4.1	1.2	-0.3
Consensus Forecasts				
World	-0.2	-2.1	2.0	1.9
USA	-1.8	-2.7	2.3	1.8
Euro area	-1.4	-3.4	0.8	0.3

Source: IMF World Economic Outlook, January and IMF World Economic Outlook, April.
OECD Economic Outlook, 2008/II, December and OECD Economic Outlook, interim report, March.
Consensus Forecasts, January and Consensus Forecasts, April.

On a quarter-on-quarter basis, growth forecasts for the US and Euro area, which makes up nearly 55 percent of global GDP, point to a major contraction in annual growth prospects in every quarter of 2009 (Table 2). A rebound is not expected before the second quarter of 2010, while many expect the US to recover earlier and stronger than the Euro area.

Table 2. Quarterly Growth Forecasts (USA and Euro Area, Year on Year Basis)

	2009				2010			
	I	II	III	IV	I	II	III	IV
USA	-2.5	-3.7	-3.5	-1.6	0.4	1.6	2.3	2.6
Euro area	-2.8	-2.9	-2.7	-1.3	-0.1	0.5	0.8	1.0

Source: Consensus Forecasts, April 2009.

In the January Inflation Report, we had built our medium-term forecasts on three different scenarios depending on the depth of the global economic contraction and the timing of a likely recovery: (i) baseline, (ii) early recovery and (iii) late recovery. In the baseline scenario, global economy was assumed to recover by early 2010. The updates to global growth forecasts within the past three months point to a more severe contraction in 2009 and a more gradual and slower rebound in 2010, compared to the outlook presented in the January Inflation Report. Thus, we now assume in our baseline scenario that global economy will face a deeper contraction in 2009 and recover later (towards mid-2010). Hence, the early recovery scenario introduced in the January Inflation Report (in which global economy recovers by the third quarter of 2009) is now off the table.

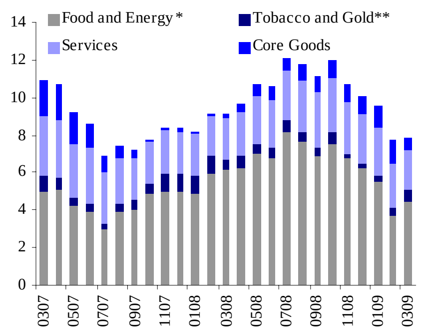
3. Inflation Developments

3.1. Inflation

Consumer prices were up 1.05 percent in the first quarter of 2009, while annual CPI inflation fell by 2.17 percentage points from end-2008 to 7.89 percent. The marked slowdown in economic activity and the moderation in cost pressures helped inflation ease further and across all sub-categories. In addition, the exchange rate pass-through continued to have a less dampening short run effect on consumer prices.

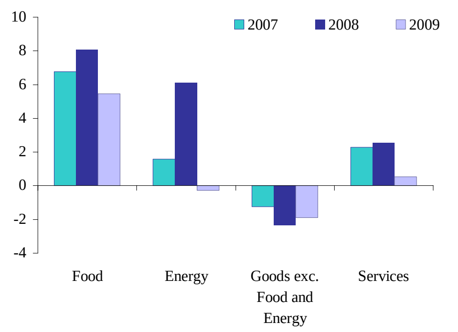
The contribution of all major categories to annual inflation, excluding tobacco and gold with skyrocketing prices, weakened in the first quarter. The contribution of food and energy to annual inflation dropped especially due to the sharp decline in annual energy inflation, while services prices continued to make a reduced contribution on lower costs and weaker domestic demand (Graph 3.1.1).

Graph 3.1.1. Contribution to Annual CPI Inflation



* Food and energy: Food, nonalcoholic beverages and energy.
** Tobacco and gold: Alcoholic beverages, tobacco and gold.
Source: TURKSTAT, CBRT.

Graph 3.1.2. CPI by Categories
(First-Quarter Percentage Change)

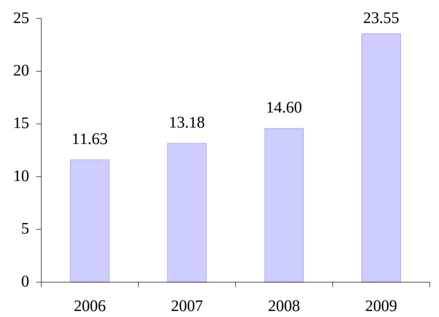


Source: TURKSTAT, CBRT.

In the first quarter, food prices increased at a more moderate pace than in previous years owing to the marked decrease in processed food inflation, while energy prices have dropped recently with the lagged impact of falling oil prices. On the other hand, prices for goods excluding food and energy declined at a less rapid pace than a year ago due to the less solid first-quarter fall in clothing prices, driven by the early launch of discounts, and rising gold and tobacco prices. Moreover, prices for services posted the slowest first-quarter increase in the history of the CPI (Graph 3.1.2).

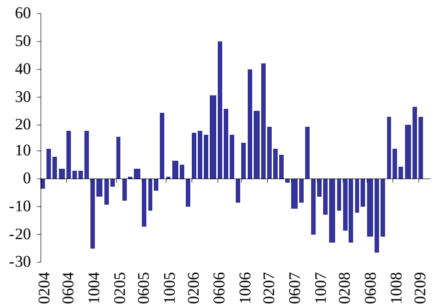
Food prices surged by 5.45 percent in the first quarter amid the steep increase in unprocessed food prices in March. After the sharp run-up in the final quarter of 2008, unprocessed food prices jumped by 13.29 percent in the first quarter, exceeding the average rates in previous years, largely due to higher vegetable prices, as in the fourth quarter of 2008 (Graph 3.1.3). The relative rebound in fruit and vegetable exports appears to be the main driver of this increase (Graph 3.1.4). Accordingly, after having declined to as low as -0.90 percent in the third quarter of 2008, annual unprocessed food inflation soared again and ended the first quarter of 2009 at 10.20 percent (Graph 3.1.5).

Graph 3.1.3. Vegetable Prices
(First-Quarter Percentage Change)



Source: TURKSTAT, CBRT.

Graph 3.1.4. Fruit and Vegetable Exports
(Annual Percentage Change)

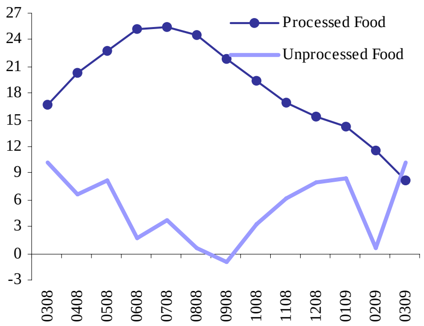


Source: TURKSTAT.

On the processed food prices front, there had been sharp month-on-month increases between the fourth quarter of 2007 and the first half of 2008 amid output losses and changing global conditions, and annual inflation had climbed to a record high of 25 percent. With the reversal of these unfavorable developments, the downward slide that started in the second half of 2008 continued into the first quarter at a more rapid pace, thanks to falling wheat prices and the resulting decline in bread and grain prices. Accordingly, processed food prices decreased by 0.93 percent on weaker total demand, and their annual rate of increase went down by 7.16 percentage points to 8.30 percent (Graph 3.1.5, Table 3.1.2). The annual rate of increase in processed food prices is expected to decelerate further in the second quarter.

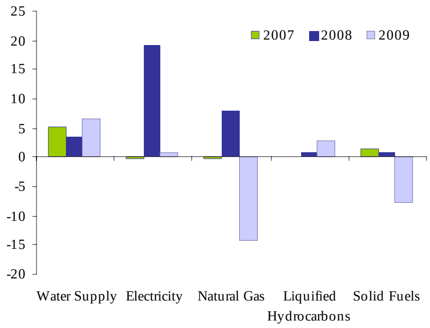
After a slower rate of increase in the fourth quarter of 2008, energy prices dropped by 0.28 percent in the first quarter (Table 3.1.2). Oil prices continued to fall and crude oil prices averaged 45 US dollars. With the lagged impact of the plunge in oil prices during the last two quarters, natural gas and solid fuel prices went down by 14.37 and 7.83 percent, respectively, while the weakening of the Turkish lira drove domestic fuel prices higher (Graph 3.1.6). Accordingly, energy inflation declined by 7.22 percentage points to 12.59 percent year-on-year in the first quarter. Annual energy price inflation is expected to slide further in coming months, given the high base from a year ago as well as the current trend in crude oil prices and the cost-based pricing.

Graph 3.1.5. Food Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

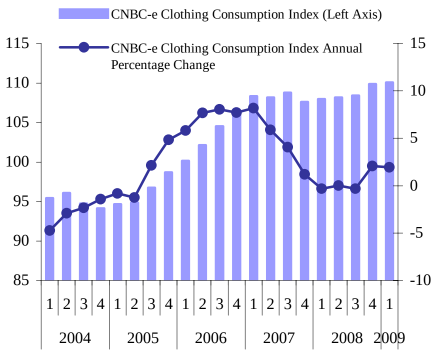
Graph 3.1.6. Residential Energy Prices
(First-Quarter Percentage Change)



Source: TURKSTAT, CBRT.

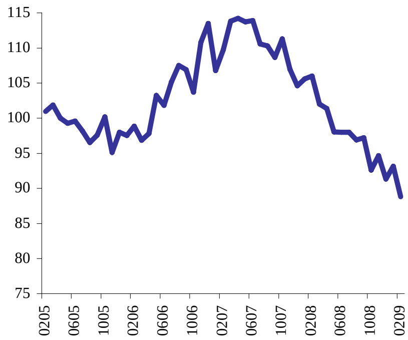
Annual inflation in goods excluding food and energy increased by 0.48 percentage points to 4.23 percent in the first quarter on the back of 26.25 percent rise in gold prices, which is in parallel with the external gold price developments. However, despite weaker Turkish lira, prices for durable goods fell with the sharp contraction in domestic demand and the Special Consumption Tax (SCT) cuts.

Graph 3.1.7. CNBC-e Clothing Consumption Index
(Seasonally Adjusted, 3-Month Average, Annual Percentage Change)



Source: CNBC-e.

Graph 3.1.8. Apparel Exports
(Seasonally Adjusted)

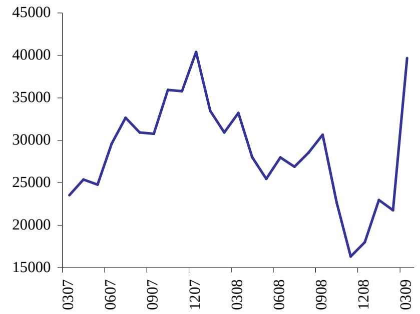


Source: TURKSTAT, CBRT.

Domestic consumer spending on clothing continued to soften in the first quarter (Graph 3.1.7). In addition, as suggested by the quantity index for apparel exports, the contraction in foreign demand grew stronger (Graph 3.1.8). As a result, clothing prices put further downward pressure on CPI inflation in the first quarter. Meanwhile, after having remained quite unchanged through 2008, prices for tobacco products surged by 7.34 percent.

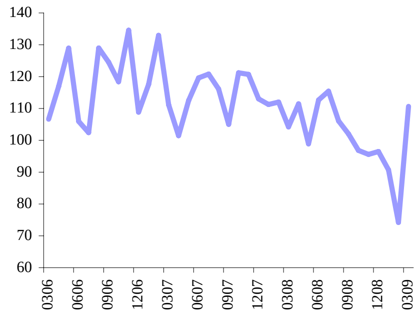
Prices for durable goods (excluding gold) decreased by 2.49 percent in the first quarter and inflation in this category dropped by 4.14 percentage points to -0.95 percent year-on-year (Table 3.1.1), mainly on account of the three-month SCT cut, effective in March, on automobiles, white goods and electronics. The main driver of the decline was the steep drop in automobile prices. The SCT cut had a particular effect on domestic sales of automobiles and household appliances in March (Graph 3.1.9, Graph 3.1.10). Moreover, the three-month Value-Added Tax (VAT) cut, effective in April, on furniture and IT products, is expected to have a dampening effect on annual durable goods inflation in the short run. Besides, the exchange rate pass-through on prices of durable goods can be partly measured following the depletion of inventories.

Graph 3.1.9. Domestic Automobile Sales
(Seasonally Adjusted, Units)



Source: AMA,CBRT.

Graph 3.1.10. CNBC-e Household Appliances Consumption
(Seasonally Adjusted)



Source: CNBC-e.

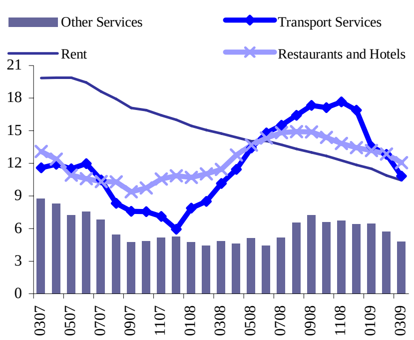
Table 3.1.1. Prices of Durable Goods
(Quarterly and Annual Percentage Change)

	2008					2009
	I	II	III	IV	Annual	I
Durable goods (excl. gold)	**1.58**	**2.81**	**-1.80**	**0.61**	**3.19**	**-2.49**
Furniture	4.13	7.60	-1.27	-1.31	9.17	-3.17
Electric and nonelectric appliances	1.16	0.68	0.12	6.04	8.13	-4.26
Automobiles	1.04	2.44	-3.63	-2.30	-2.56	-1.36
Other	0.04	0.89	1.02	2.27	4.29	0.36

Source: TURKSTAT, CBRT.

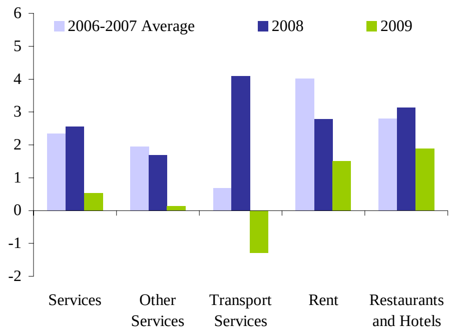
Being on the decline since the final quarter of 2008, the rate of increase in services prices continued to decelerate in the first quarter of 2009 on markedly lower costs and weaker domestic demand. Services prices were up 0.53 percent in the first quarter, the slowest quarter-on-quarter increase in the history of the CPI, and fell from 10.46 to 8.29 percent year-on-year (Table 3.1.2).

Graph 3.1.11. Prices of Services
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

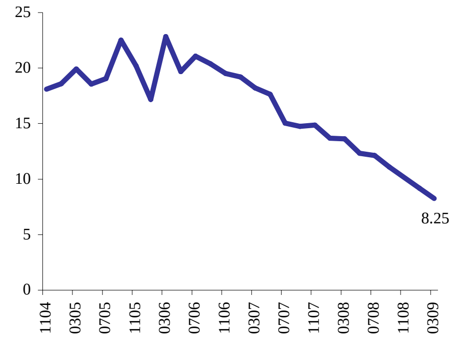
Graph 3.1.12. Prices of Services
(First-Quarter Percentage Change)



Source: TURKSTAT, CBRT.

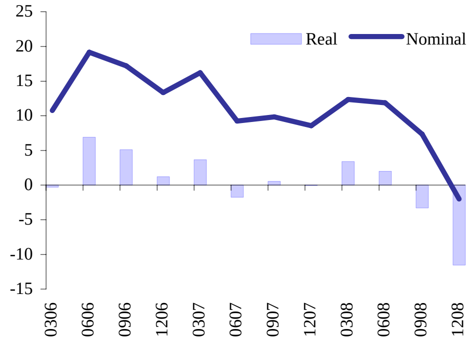
The rate of increase in services prices slowed across all subcategories (Graph 3.1.11). The lagged impact of falling international oil prices put some downward pressure on transport prices in the first quarter. Price changes were substantially lower than their year-ago averages in rents, due to the softening in domestic demand, and in restaurants and hotels, due to both weakening domestic demand and slowing food prices (Graph 3.1.12). Especially the decline in annual rental inflation was highly significant. According to seasonally adjusted data, the decline in annual rental inflation intensified in the first quarter (Graph 3.1.13). Furthermore, according to the turnover index for services, the level of which is a key indicator of the softening in domestic demand, services demand was weaker than a quarter and a year ago (Graph 3.1.14). On balance, services prices are expected to edge further down in the upcoming period.

Graph 3.1.13. Rents
(Seasonally Adjusted, Annualized, 2-Month Average)



Source: TURKSTAT, CBRT.

Graph 3.1.14. Turnover Index for Services*
(Annual Percentage Change, Nominal and Real)



* TURKSTAT Short-Term Business Statistics, Trade and Services Indicators.
Source: TURKSTAT, CBRT.

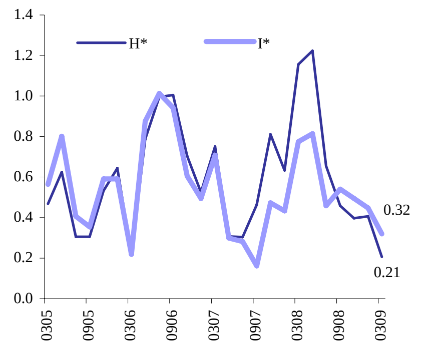
Table 3.1.2. Prices of Goods and Services
(Quarterly and Annual Percentage Change)

	2008					2009
	I	II	III	IV	Annual	I
CPI	**3.09**	**2.82**	**0.78**	**3.03**	**10.06**	**1.05**
1. Goods	**3.27**	**2.69**	**0.05**	**3.61**	**9.93**	**1.22**
Energy	6.11	4.12	6.41	1.91	19.81	-0.28
Unprocessed food	10.90	-13.25	-0.29	12.45	7.87	13.29
Processed food	5.61	8.06	1.37	-0.20	15.46	-0.93
Goods excl. energy and food	-2.35	6.87	-3.52	3.04	3.75	-1.89
Durable goods	3.45	1.97	-2.34	2.45	5.54	-0.27
Durable goods (excl. gold)	1.58	2.81	-1.80	0.61	3.19	-2.49
Semi-durable goods	-1.23	9.20	0.01	3.42	11.54	-3.46
Non-durable goods	6.44	-1.43	0.74	4.07	9.99	5.21
2. Services	**2.55**	**3.20**	**2.94**	**1.39**	**10.46**	**0.53**
Rents	2.79	2.74	3.58	2.25	11.85	1.51
Restaurants and hotels	3.13	4.58	2.77	2.34	13.44	1.88
Transport	4.10	5.98	4.35	1.54	16.89	-1.29
Other	1.68	1.80	2.29	0.49	6.40	0.13

Source: TURKSTAT, CBRT.

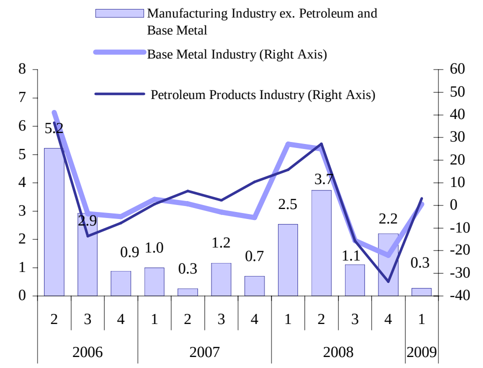
The CPI index excluding energy, unprocessed food, alcoholic beverages, tobacco and gold (SCA-H) fell by 2.66 percentage points year-on-year, while, with a further exclusion of processed food, the index (SCA-I) dropped by 1.41 percentage points year-on-year. The SCT cut that has been in place since mid-March contributed to the decline in both indices, but even if the contribution of the tax cut excluded, the seasonally adjusted rate of change in both indices still continued to fall, suggesting that inflation remained on a downward track (Graph 3.1.15).

Graph 3.1.15. Core CPI Measures H* and I*
(Seasonally Adjusted Monthly Increases, 2-Month Average)



* SCT-adjusted H and I measures.
Source: TURKSTAT, CBRT.

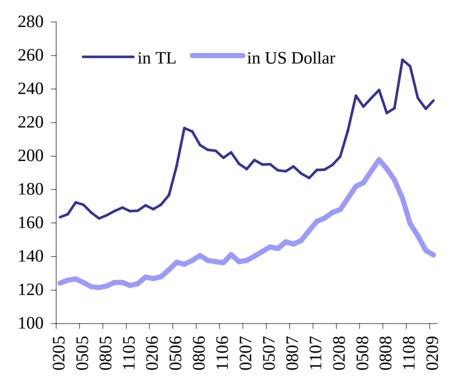
Graph 3.1.16. Manufacturing Industry Prices
(Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

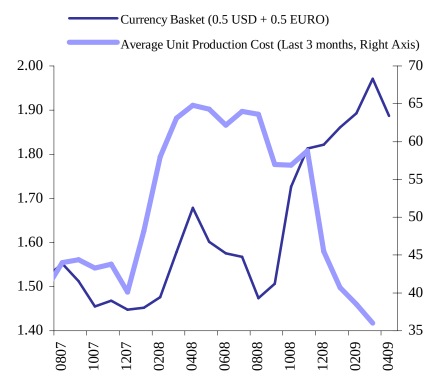
Changes in producer prices are of great importance as to their cost pressure on CPI inflation. After having slumped by the second half of 2008 amid plunging energy and commodity prices, producer prices rose by 1.70 percent in the first quarter of 2009. The recent sharp decline in producer prices for base metals and petroleum products was replaced by an increase in the first quarter. On the other hand, excluding base metals and oil, producer prices soared by a slight 0.27 percent (Graph 3.1.16). Meanwhile, producer prices for furniture and apparel manufacturing dropped by 7.34 and 5.74 percent, respectively, pointing to a reduced cost pressure in these industries.

Graph 3.1.17. Import Unit Value Index



Source: TURKSTAT.

Graph 3.1.18. Average Unit Cost* and Currency Basket



* From the CBRT Business Tendency Survey.
Source: CBRT.

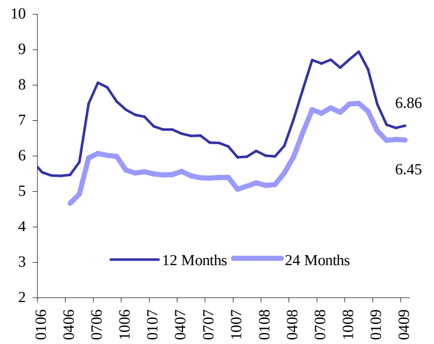
Import prices continued to decline in the first quarter (Graph 3.1.17), which suggests that falling import prices offset the likely pressure from exchange rate movements on prices. In fact, the CBRT Business Tendency

Survey results indicate that the average unit cost is headed downward, despite the exchange rate movements in the fourth-quarter of 2008 (Graph 3.1.18). In sum, the exchange rate pass-through on producer prices has been compensated by falling commodity prices and weaker foreign demand since the fourth quarter of 2008, resulting in no cost pressure on inflation.

3.2. Expectations

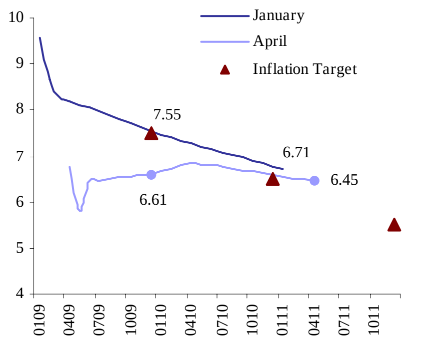
The economic slowdown, falling commodity prices and data releases suggesting a rapid disinflation, as forecast by the CBRT, caused inflation expectations to decelerate further in the first quarter of 2009. The rise in annual inflation during March, the transient characteristic of which is emphasized by CBRT, did not lead to any deterioration in short-term expectations, and expectations continued to decelerate in March and April (Graph 3.2.1).

Graph 3.2.1. 12- and 24-Month Ahead CPI Expectations*
(Annual Percentage Change)



* CBRT Business Tendency Survey results from the second survey period.
Source: CBRT.

Graph 3.2.2. Inflation Expectations Curve*
(Annual Percentage Change)

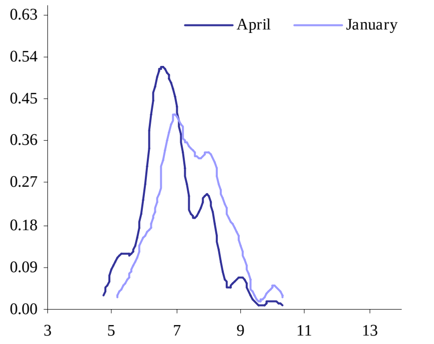


* Calculated using linear interpolation of several maturity yields in the CBRT Expectations Survey. Yields are from the second survey period.
Source: CBRT.

Inflation expectations decreased for all terms in April, compared to January. The fall in near-term inflation expectations became more pronounced and the expectations curve flattened. Currently, expectations for end-2009 are anchored at 6.61 percent, well below the target. On the other hand, the end-2010 inflation expectations appear to have become consistent with the target at 6.5 percent (Graph 3.2.2).

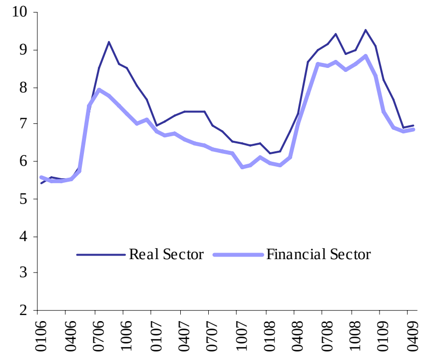
The distribution of inflation expectations indicate that expectations in April were quite lower than those in January, and participants' expectations became increasingly uniform (Graph 3.2.3).

Graph 3.2.3. Distribution of 12-Month Ahead CPI Inflation Expectations*



*Horizontal axis shows inflation rate, vertical axis indicates Kernel forecast. Yields are from the second survey period.
Source: CBRT.

Graph 3.2.4. 12-Month Ahead CPI Expectations



* CBRT Expectations Survey results from the second survey period.
Source: CBRT.

Lastly, on the financial and real sector front, participants' inflation expectations continued to improve, but expectations of participants from the real sector were slightly more elevated (Graph 3.2.4).

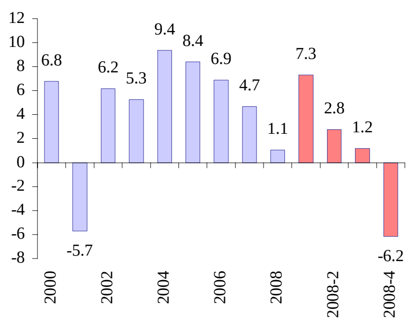
4. Supply and Demand Developments

Recent data releases indicate that the economy plunged into a deeper contraction. In the last quarter of 2008, GDP contracted sharply quarter-on-quarter, and narrowed year-on-year for the first time in a long time. As the economic contraction spilled over into the labor market, non-farm unemployment rose at a record pace to a historic high. Thus, total demand conditions provided an added support to disinflation, and according to recent readings, this outlook has become stronger in the first quarter of 2009. The run-up in unemployment puts pressure on wages across the whole economy and tightens total demand. In addition to the monetary policy rate easing cycle that has been in place for quite some time, fiscal measures intended to stimulate the economy are expected to help promote domestic demand. Yet, given the tightening of financial conditions and heightened signs of a protracted global recession, the level of economic activity is expected to have further downward pressure on inflation for a long period of time.

4.1. Gross Domestic Product Developments and Domestic Demand

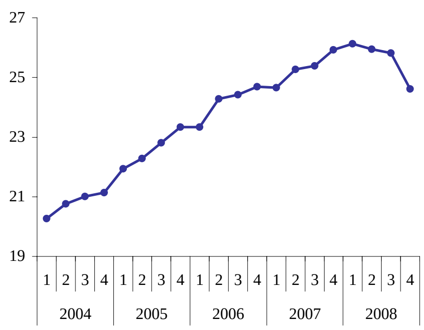
According to the national income data released by the Turkish Statistical Institute (TURKSTAT), GDP shrunk by 6.2 percent in the fourth quarter of 2008 from a year earlier. With upward revisions to the figures of the first nine months, GDP grew by 1.1 percent in 2008 (Graph 4.1.1).

Graph 4.1.1. GDP Growth by Periods
(Percent)



Source: TURKSTAT.

Graph 4.1.2. GDP
(Seasonally Adjusted, at 1998 Prices, Billion TL)

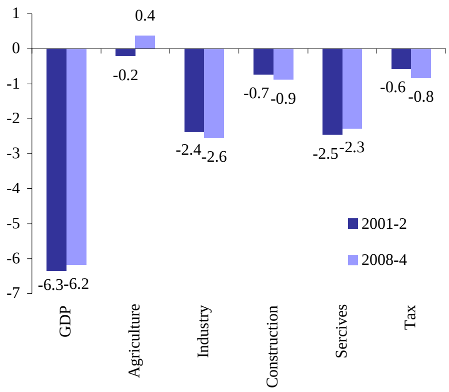


Source: TURKSTAT, CBRT.

Annual growth rates were down both in quarterly and seasonally adjusted terms. After having slowed quarter-on-quarter in the second and third quarters of 2008, GDP narrowed by a stunning 4.7 percent in the fourth quarter, which points to a deeper economic contraction (Graph 4.1.2).

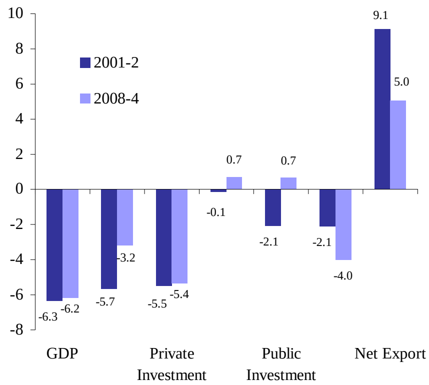
On the production side, all industries excluding agriculture made a negative contribution to GDP growth. Both the GDP growth rate and the composition of production industries in the fourth quarter of 2008 and during the economic crisis in 2001 seem quite alike (Graph 4.1.3). Yet, the comparison should also be made in terms of spending, in order to track the source of economic shocks and, thus, to forecast the timing of economic recovery. To this end, it would be better to exclude the additional periodic contribution from public spending and focus on other components. Firstly, excluding public demand, the difference in growth rates between the comparable periods offers a more negative outlook for the current period. Inventory depletion is much stronger in the current period than in 2001, which explains the relative size of total demand shocks and the steep decline in capacity utilization. Moreover, the difference between private consumption demand and net export performance point to a more modest contraction in domestic demand in the current period and to the adverse impact of global shocks on net foreign demand (Graph 4.1.4).

Graph 4.1.3. Contribution to GDP Growth from Production
(Percentage Point)



Source: TURKSTAT.

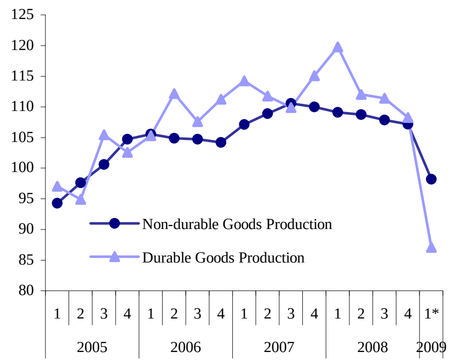
Graph 4.1.4. Contribution to GDP Growth from Spending
(Percentage Point)



Source: TURKSTAT.

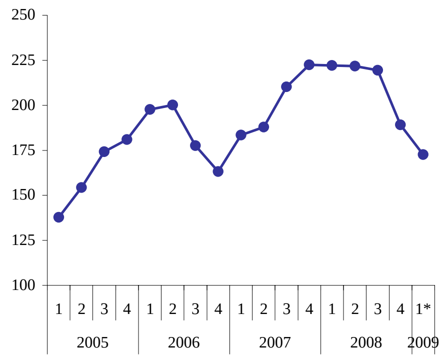
In order to assess the near-term outlook for domestic demand, it would be more appropriate to analyze the industrial production data and foreign trade quantity indices by main industry groupings. Production and imports of consumption goods fell sharply during January-February from a quarter earlier (Graph 4.1.5 and 4.1.6), which suggests that the slowdown in private consumption demand intensified in the first quarter of 2009 both in quarterly and yearly terms (Graph 4.1.7).

Graph 4.1.5. Production Index for Consumption Goods
(Seasonally Adjusted, 2005=100)



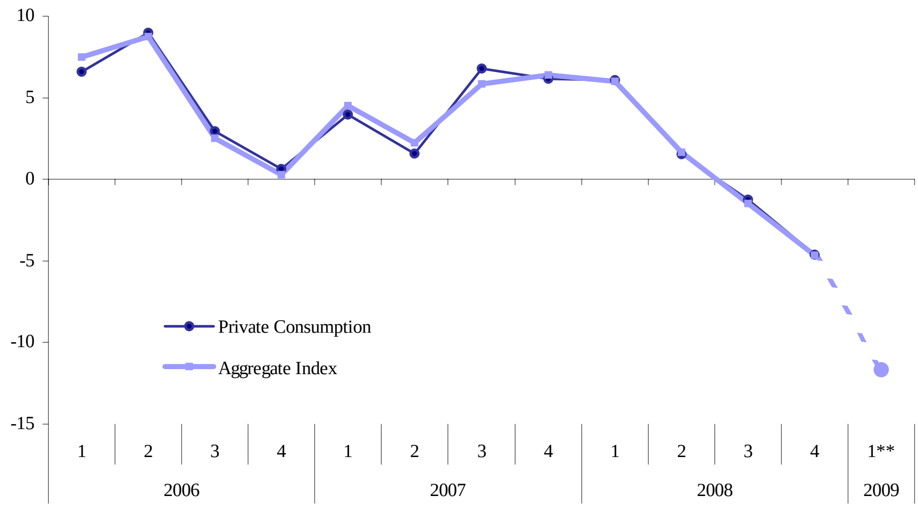
* January-February figures.
Source: TURKSTAT, CBRT.

Graph 4.1.6. Import Quantity Index for Consumption Goods
(Seasonally Adjusted, 2003=100)



* January-February figures.
Source: TURKSTAT, CBRT.

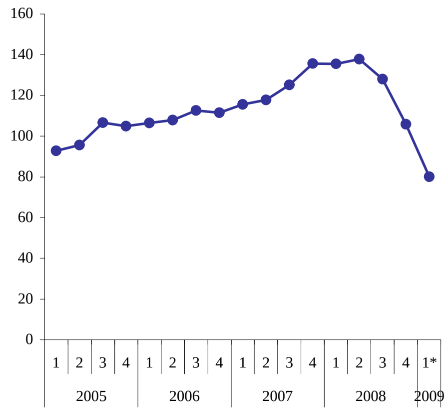
Graph 4.1.7. Aggregate Index of Consumer Sentiment* and Private Consumption Expenditures
(Annual Percentage Change)



* Derived from data on production and imports of consumption goods.
** January-February figures.
Source: TURKSTAT, CBRT.

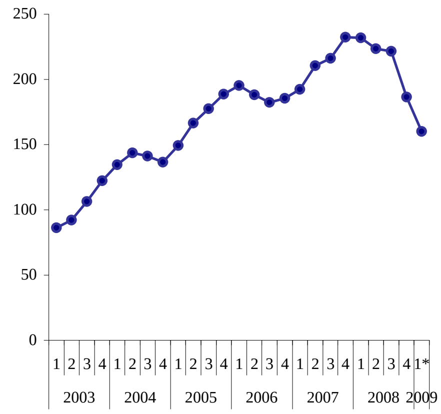
Indicators for private investment spending, another major component of domestic demand, continued to decline in the first quarter of 2009. Production and imports of capital goods dropped by 44.9 and 38.2 percent year-on-year, respectively, during January-February, and edged further down quarter-on-quarter in seasonally adjusted terms (Graph 4.1.8, Graph 4.1.9). Readings on production, imports and exports of investment goods indicate that machinery-equipment investments fell sharply both in quarterly and yearly terms in the first quarter (Graph 4.1.10).

Graph 4.1.8. Production Index for Capital Goods
(Seasonally Adjusted, 2005=100)



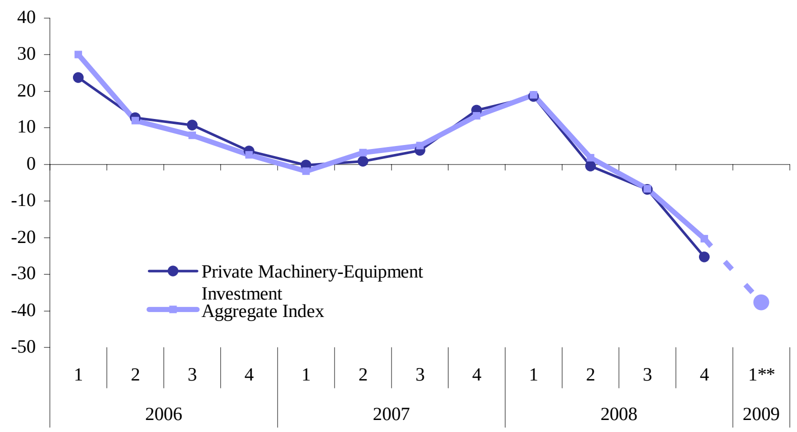
* January-February figures.
Source: TURKSTAT, CBRT.

Graph 4.1.9. Import Quantity Index for Capital Goods
(Seasonally Adjusted, 2003=100)



* January-February figures.
Source: TURKSTAT, CBRT.

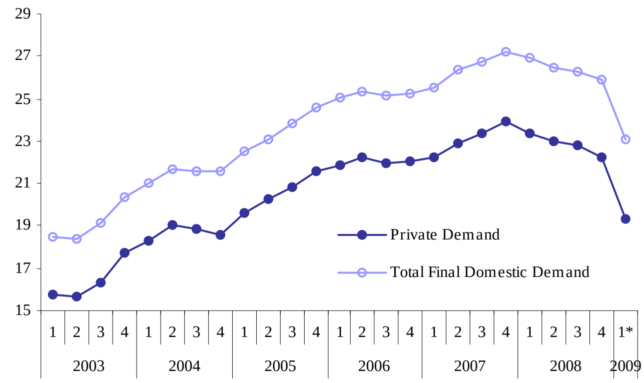
Graph 4.1.10. Aggregate Index of Investment Sentiment* and Machinery-Equipment Investments
(Annual Percentage Change)



* Derived from data on production and imports of investment goods.
** January-February figures.
Source: TURKSTAT, CBRT.

In sum, data on private consumption and investment demand indicate that both spending items continued to slow down quarterly and annually in the first quarter of 2009. Although public spending is expected to make a positive contribution to growth in the first quarter, total final domestic demand is anticipated to have contracted at a more rapid pace amid weaker private demand (Graph 4.1.11).

Graph 4.1.11. Private Demand and Total Final Domestic Demand
(Seasonally Adjusted, at 1998 Prices, Billion TL)

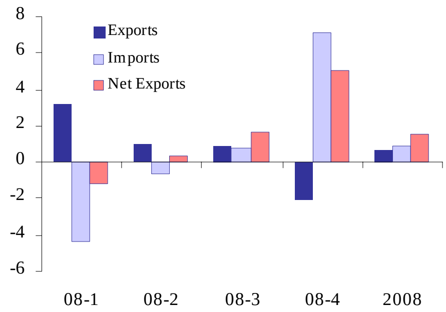


* Forecast.
Source: TURKSTAT, CBRT.

4.2. Foreign Demand

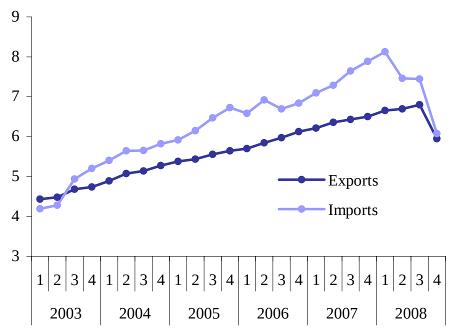
Exports and imports plunged by 8.2 and 23 percent year-on-year, respectively, in the fourth quarter of 2008. Accordingly, net exports added 5 percentage points to GDP growth in the fourth quarter, accounting for –2.1 and 7.2 percentage points, respectively, of export and import growth. Exports made its first negative contribution to growth since the final quarter of 1999, which is a clear evidence of foreign demand contraction caused by the global economic turmoil. On the other hand, the sharp downturn in imports from a year earlier amid weaker total demand has been the major driver of the massive contribution from net exports to GDP growth (Graph 4.2.1). Based on seasonally adjusted terms, both imports and exports fell rapidly in the fourth quarter of 2008, reducing the foreign trade deficit. In view of both current trends and the base effect, net exports are expected to make a substantial contribution to GDP growth in the first quarter of 2009.

Graph 4.2.1. Contribution to Growth from Net Exports
(Percentage Points)



Source: TURKSTAT.

Graph 4.2.2. Exports and Imports of Goods and Services
(Seasonally Adjusted, at 1998 Prices, Billion TL)



Source: TURKSTAT, CBRT.

In view of the above identification of the source of shocks that Turkey has been exposed to, keeping track on changes in international economies has become increasingly important. The global economic outlook deteriorated further in the first quarter of 2009, while growth forecasts for advanced economies, except for the United States, continued to be revised downward in April. Consensus Forecasts revised its contraction forecast for the euro area – Turkey's greatest export market – in 2009 upwards to 3.4 percent in its April Survey, from 2.6 percent in its March Survey (Table 4.1.1).

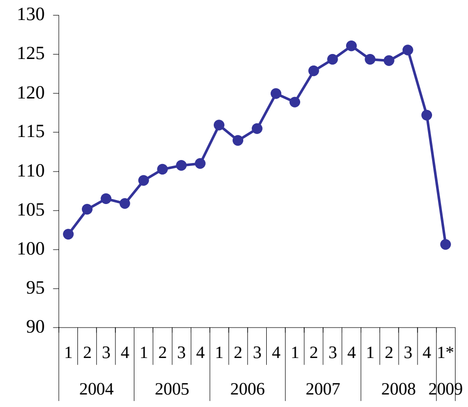
Table 4.1.1. Consensus Forecasts
(Survey Date: April 14, 2009)

GDP Growth	Historical Data				Forecasts for 2009 from Survey of							
	2005	2006	2007	2008	Sep 08	Oct 08	Nov 08	Dec 08	Jan 09	Feb 09	Mar 09	Apr 09
United States	2.9	2.8	2.0	1.1	1.4	0.0	-0.6	-1.3	-1.8	-2.1	-2.8	-2.7
Euro Zone	1.8	3.0	2.7	0.7	0.9	0.5	-0.2	-0.9	-1.4	-2.0	-2.6	-3.4
Japan	1.9	2.1	2.4	-0.7	0.9	0.5	-0.1	-0.9	-1.7	-3.8	-5.8	-6.3
UK	2.1	2.8	3.0	0.7	0.6	-0.2	-0.9	-1.5	-2.2	-2.6	-3.0	-3.3

Source: Consensus Forecasts, April.

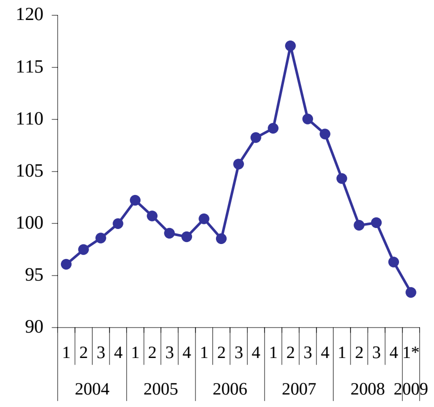
Accordingly, foreign demand conditions appear to have continued to deteriorate in the first quarter. In fact, seasonally adjusted data from leading export industries suggest that the downturn continued in the first quarter, compared to a quarter earlier (Graph 4.2.3 – 4.2.6).

Graph 4.2.3. Quantity Index for Textile Exports
(Seasonally Adjusted, 2003=100))



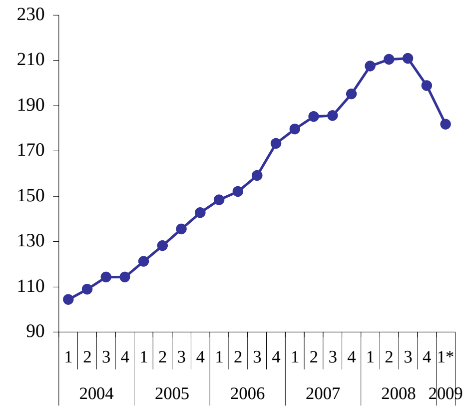
* January-February figures.
Source: TURKSTAT, CBRT.

Graph 4.2.4. Quantity Index for Clothing Exports
(Seasonally Adjusted, 2003=100))



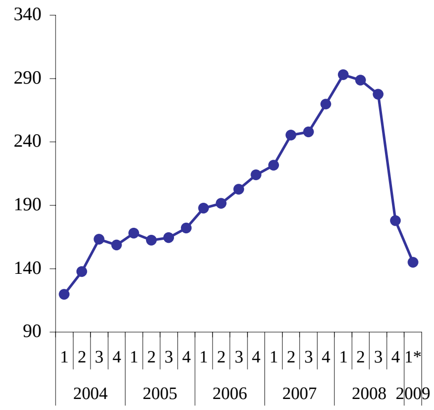
* January-February figures.
Source: TURKSTAT, CBRT.

Graph 4.2.5. Quantity Index for Machinery-Equipment Exports
(Seasonally Adjusted, 2003=100))



* January-February figures.
Source: TURKSTAT, CBRT.

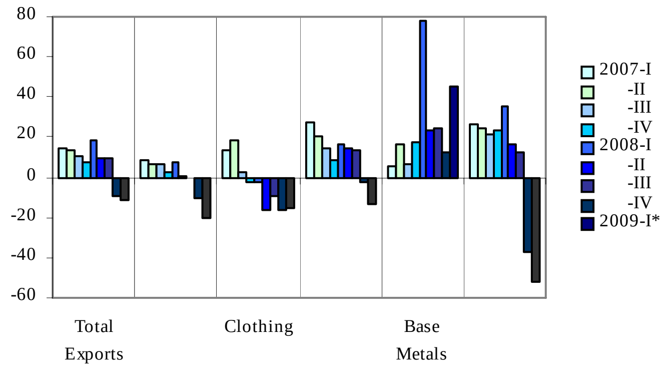
Graph 4.2.6. Quantity Index for Motor Vehicle Exports
(Seasonally Adjusted, 2003=100))



* January-February figures.
Source: TURKSTAT, CBRT.

The most striking evidence of foreign demand contraction is the quantity for motor vehicle exports that was almost reduced to half in the last two quarters. Similarly, exports of machinery-equipment and textiles dropped dramatically, and the downtrend in clothing exports that started in mid-2007 continued into the first quarter of 2009. On the other hand, the base metals industry expanded by a remarkable 46.6 percent year-on-year during January-February 2009 on account of the marked increase in gold exports, and made a positive contribution to total exports (Graph 4.2.7).

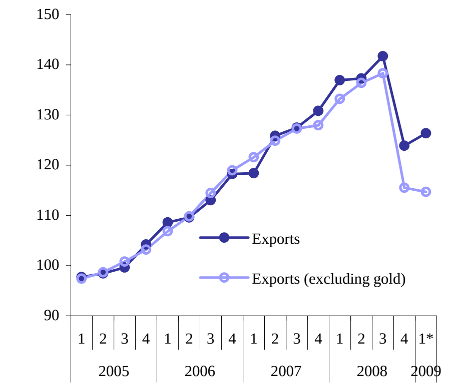
Graph 4.2.7. Export Quantity Index Growth by Industries
(Annual Percentage Change)



* January-February figures.
Source: TURKSTAT.

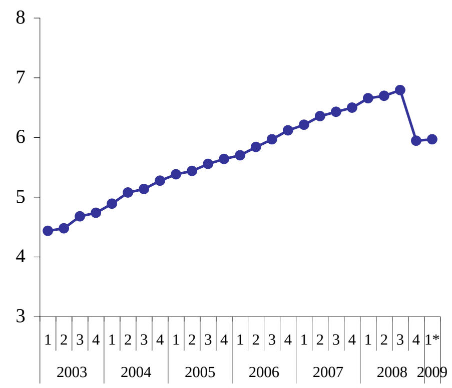
In the first quarter, quantity index for exports excluding gold continued to decline in seasonally adjusted terms, indicating that exports remained on a downward trend (Graph 4.2.8). Meanwhile, the extraordinary increase in gold exports amid global financial uncertainties and the data on tourism revenues indicate that the falling trend in exports of goods and services, which started in the final quarter of 2008, flattened out in the first quarter of 2009. On balance, exports of good and services are expected to remain low and decline further on annual basis in the first quarter (Graph 4.2.9).

Graph 4.2.8. Quantity Index for Exports
(Seasonally Adjusted, 2005=100)



* January-February figures.
Source: TURKSTAT, CBRT.

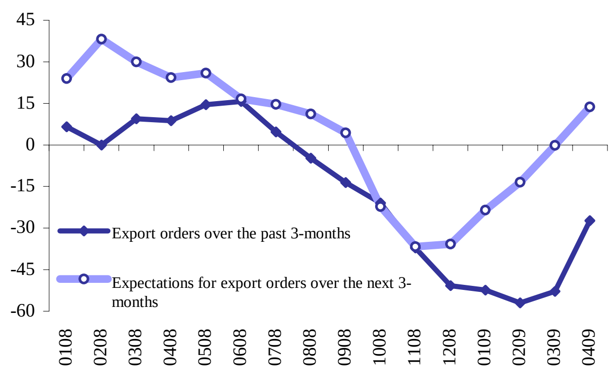
Graph 4.2.9. Exports of Goods and Services
(Seasonally Adjusted, at 1998 Prices, Billion TL)



* Forecast.
Source: TURKSTAT, CBRT.

Export orders over the past three months, a CBRT Business Tendency Survey indicator, confirm the abovementioned first-quarter outlook, and are expected to improve in the subsequent period (Graph 4.2.10), which suggests that the falling trend in exports will be replaced by a slight rebound by the second quarter. Given the mounting signs of a prolonged economic downturn, foreign demand is expected to put further pressure on total demand in 2009.

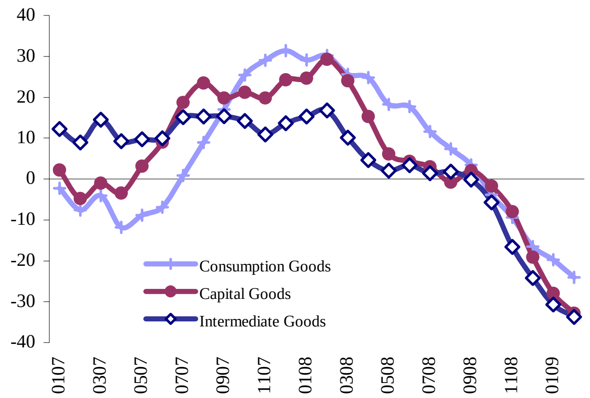
Graph 4.2.10. Export Orders and 3-Month Ahead Expectations
(Up-Down)



Source: TURKSTAT, CBRT.

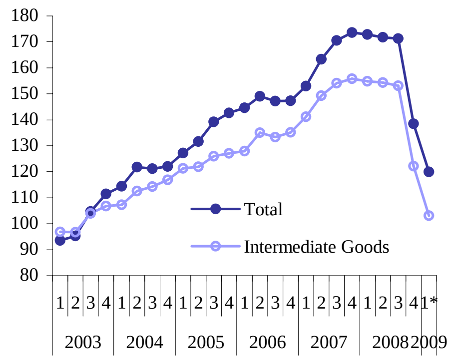
The slowdown in imports became more pronounced with the massive softening in domestic demand and the reduction in import prices. The import quantity index contracted by 35.9 percent year-on-year during January-February, and continued to slow quarter-on-quarter in seasonally adjusted terms. Among major components of imports, in addition to consumption and investment goods mentioned in Part 4.1, the demand for imported intermediate goods weakened significantly due to the sharp contraction in industrial production (Graph 4.2.11 and 4.2.12). On balance, imports of goods and services are expected to decline further quarter-on-quarter in the first quarter of 2009 (Graph 4.2.13).

Graph 4.2.11. Import Quantity Index Growth by Industries
(Annual Percentage Change)



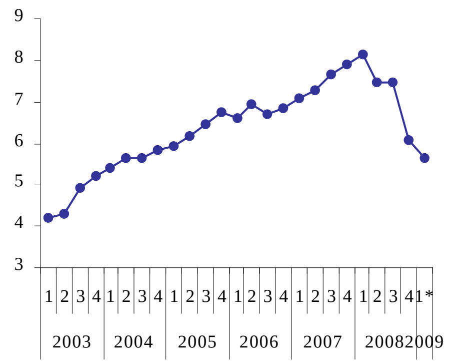
Source: TURKSTAT.

Graph 4.2.12. Quantity Index for Imports
(Seasonally Adjusted, 2003=100)



* January-February figures.
Source: TURKSTAT, CBRT.

Graph 4.2.13. Imports of Goods and Services
(Seasonally Adjusted, at 1998 Prices, Billion TL)

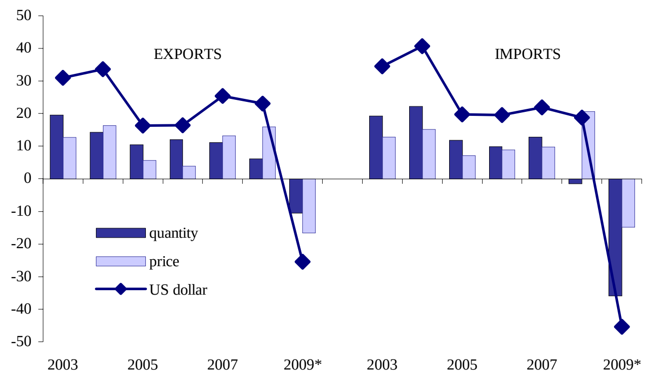


* Forecast.
Source: TURKSTAT, CBRT.

Total demand conditions will determine the upcoming direction of the demand for imported goods. In view of the above outlook, both the monetary policy easing cycle that has been in place for quite some time and the fiscal measures are expected to help promote domestic demand gradually, while foreign demand is expected to turn around at a later time due to the relatively prolonged global downturn. With the improvement in domestic demand, imports are expected to recover gradually by the second quarter, but register a negative annual growth rate until the final quarter. Accordingly, net foreign demand is forecasted to make further positive contribution to growth in the first half of 2009.

So far, we have sought to assess quantities from a national income accounts perspective, but recent developments in terms of trade are also significant. Foreign trade prices continued to surge in 2008, particularly until July, causing exports and imports to grow faster in US dollar terms (Graph 4.2.14). However, by mid-2008, foreign trade prices began to plunge with falling commodity prices amid mounting strains in global financial markets during October-November. The decline in foreign trade prices is expected to put considerable downward pressure on domestic prices of imported goods in 2009.

Graph 4.2.14. Export and Import Growth
(Annual Percentage Change)



* January-February figures.
Source: TURKSTAT.

4.3. Output Gap

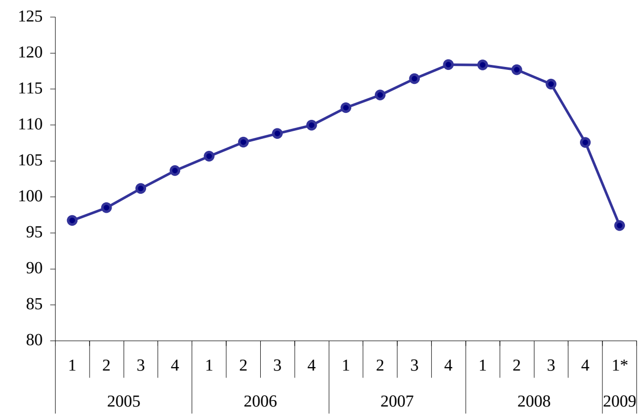
The fourth-quarter national accounts data were largely consistent with projections from the January Inflation Report. Accordingly, domestic demand made a reduced contribution to growth, whereas, despite sluggish exports, net foreign demand provided a stronger boost to growth than in the previous quarter, thanks to the severe contraction in imports.

With regard to seasonally adjusted spending, private demand continued to fall at a more solid pace, while public spending made a positive contribution to growth. With the deepening of the global economic slowdown, the outlook for foreign demand deteriorated rapidly and exports slumped sharply. As suggested by the outlook for total demand components, GDP narrowed substantially from a quarter earlier. Accordingly, the support from total demand to disinflation grew larger in the final quarter of 2008.

Fourth-quarter developments in economic activity were consistent with the projections in the January Inflation Report, but the outlook for global growth and foreign demand was weaker than projected in the first quarter of 2009. Heightened concerns about a prolonged global economic downturn and weakening of foreign demand point to a long-lasting exposure to shocks, and thus, worsen the problems in labor markets, resulting in a rapid fall in domestic demand in the first quarter.

In fact, on a quarterly basis, first-quarter indicators in 2009 point to a private sector-driven sharp fall in domestic demand and a continued downward movement in foreign demand. Parallel to reduced total demand, companies continued to deplete their inventories and slowed their production output to a great extent. As a result, industrial production narrowed by 22.5 percent year-on-year during January-February, at a more solid pace than in a quarter ago in seasonally adjusted terms (Graph 4.3.1).

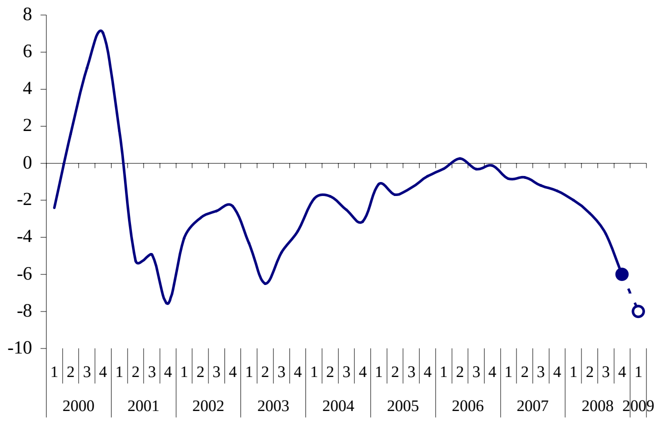
Graph 4.3.1. Industrial Production Index
(Seasonally Adjusted, 2005=100)



* Production growth forecast for March.
Source: TURKSTAT, CBRT.

In sum, according to current indicators, the global turmoil had a growing impact on domestic demand in the first quarter of 2009. Accordingly, the industrial value added as well as the value added of construction and services are anticipated to have fallen sharply both in quarterly and yearly terms. Therefore, GDP is forecast to slump further quarter-on-quarter in the first quarter and plunge to a historic low year-on-year. On balance, total demand conditions are expected to provide an added support to disinflation in the first quarter (Graph 4.3.2).[1]

Graph 4.3.2. Output Gap
(Percent)



Source: CBRT.

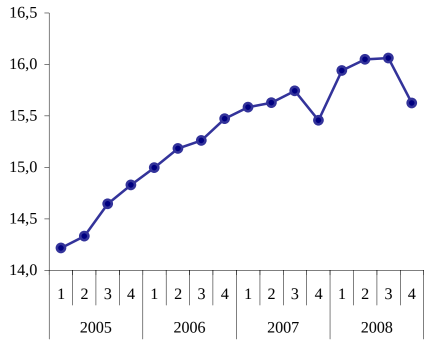
We expect the monetary easing cycle and the fiscal measures intended to stimulate the economy to be partially effective and help promote domestic demand in the remainder of the year. However, a solid recovery in domestic credit markets is quite unlikely until problems in the global economy are solved. The credit crunch and the rising corporate credit demand for debt restructuring indicate that credit channels have recently given less support to production, which is confirmed by the fact that corporate and total loans continued to fall in March, despite the slight rebound in consumer loans. On balance, total demand conditions are expected to support disinflation further for quite a long time.

[1] Output gap forecasts for 2009 and onwards are presented in the final chapter of the Report.

4.4. Labor Market

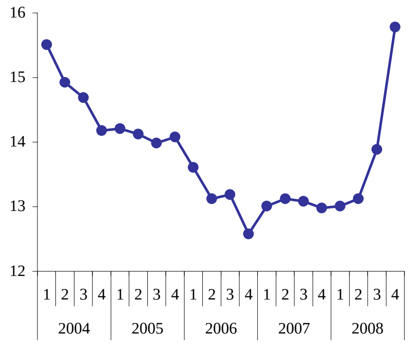
Data on the labor market confirm the deepening of the economic slowdown. Although non-farm employment increased by 1.1 percent year-on-year in the fourth quarter of 2008 due to the low base from a year earlier, it dropped sharply quarter-on-quarter in seasonally adjusted terms (Graph 4.4.1). Given the decline in non-farm employment and the rapid increase in labor force participation, non-farm unemployment rose by a dramatic 2.8 percentage points year-on-year and 1.9 percentage points quarter-on-quarter (Graph 4.4.2).

Graph 4.4.1. Non-Farm Employment
(Seasonally Adjusted, Million Employees)



Source: TURKSTAT, CBRT.

Graph 4.4.2. Non-Farm Unemployment
(Seasonally Adjusted, Percent)

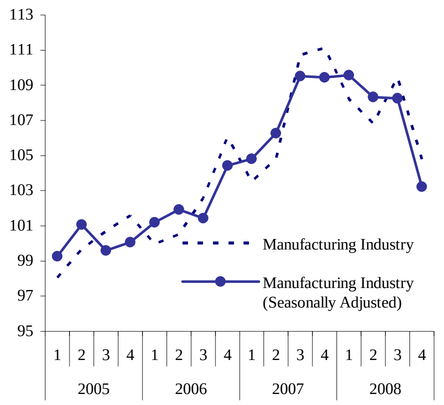


Source: TURKSTAT, CBRT.

Although non-farm employment data are crucial for a better assessment of economic performance, they are not always adequate. In order to keep track of the main course of employment, it is important that the relatively external movements of employment, which are isolated from the general macroeconomic environment, be excluded. In this context, it would be rather useful to take into account the behavior of the public sector, where employment decisions are taken regardless of conventional transmission channels. In other words, “non-farm private sector” data are of greater use for keeping track of the main course of employment. Within this framework, fourth-quarter data suggest that the deterioration in the main course of employment is much worse than indicated in non-farm employment figures (Box 4.1).

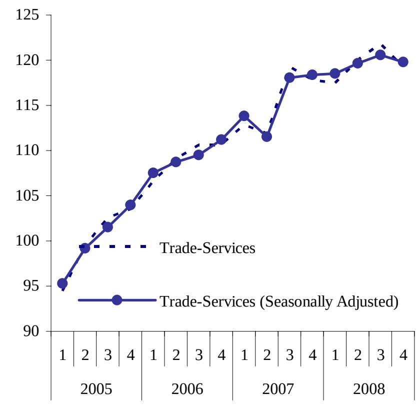
Problems in the labor market put downward pressure on total wages across the whole economy. During the fourth quarter of 2008, real wages in all manufacturing sub-industries, excluding coke and refined petroleum products, declined in both quarterly and yearly terms due to plunging foreign demand. However, real wages in the trade-services industry, which is relatively more sensitive to domestic demand, dropped at a more modest pace than in manufacturing industries. As for construction industry, real wages differ in building and non-building construction. Real wages in building construction declined rapidly, while those in non-building construction continued to rise (Graph 4.4.3 – 4.4.6).

Graph 4.4.3. Real Wages in Manufacturing Industry
(2005=100)



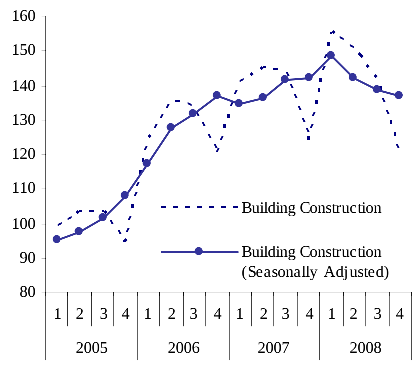
Source: TURKSTAT, CBRT.

Graph 4.4.4. Real Wages in Trade-Services Industry
(2005=100)



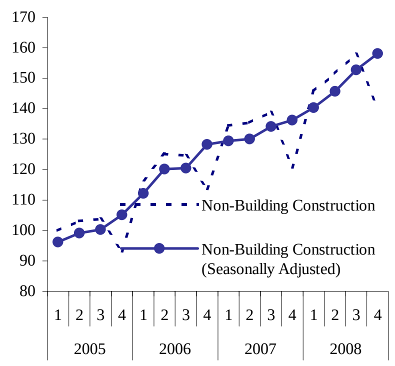
Source: TURKSTAT, CBRT.

Graph 4.4.5. Real Wages in Building Construction Industry
(2005=100)



Source: TURKSTAT, CBRT.

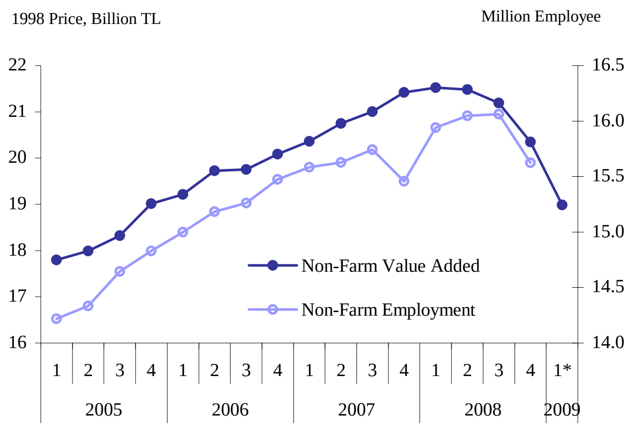
Graph 4.4.6. Real Wages in Non-Building Construction Industry
(2005=100)



Source: TURKSTAT, CBRT.

The upcoming trend in employment is essential for the demand and inflation outlook. Recent data indicate that the economic slowdown in non-farm industries deepened further in the first quarter of 2009. In view of the lagged relationship between non-farm value-added and employment, employment is expected to fall further in the first quarter (Graph 4.4.7).

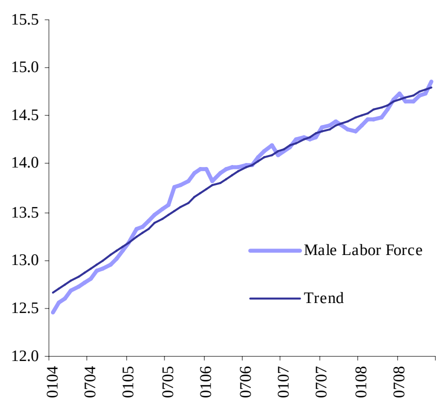
Graph 4.4.7. Value-Added and Employment in Non-Farm Industry
(Seasonally Adjusted)



* Forecast.
Source: TURKSTAT, CBRT.

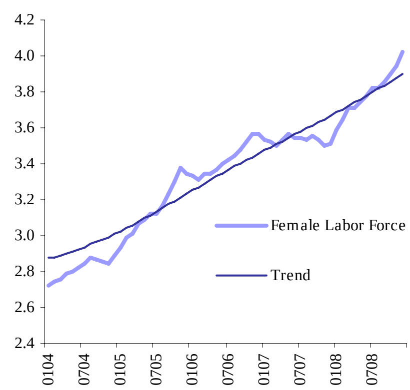
In fact, data from the December 2008-February 2009 period point to a further worsening of non-farm employment and unemployment rates. In that period, non-farm unemployment increased by 5.3 percentage points from a year earlier to 19 percent, and total unemployment by 3.9 percentage points to 15.5 percent. Among sources of rising unemployment, the slight increase in labor force participation played a limited role, but the fall in male employment was the main driver of unemployment (Graph 4.4.8 - Graph 4.4.11).

Graph 4.4.8. Non-Farm Labor Force, Male
(Million Employees)



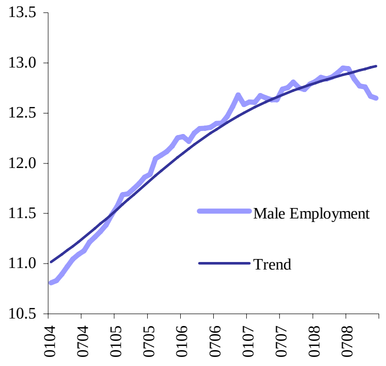
Source: TURKSTAT, CBRT.

Graph 4.4.9. Non-Farm Labor Force, Female
(Million Employees)



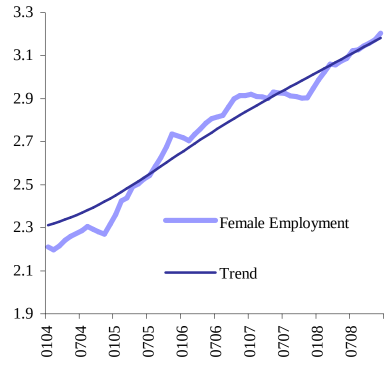
Source: TURKSTAT, CBRT.

Graph 4.4.10. Non-Farm Employment, Male
(Million Employees)



Source: TURKSTAT, CBRT.

Graph 4.4.11. Non-Farm Employment, Female
(Million Employees)



Source: TURKSTAT, CBRT.

The downward movement in economic activity and employment is expected to have further dampening effect on real wages across the whole economy in the first quarter of 2009. In the labor-intensive services industry, the recent employment losses put pressure on total wages. In the trade-services industry, the rising trend in employment, since early 2007, and in real wages, since mid-2007, has been broken. Besides, near-term developments even signal a downward shift (Graph 4.4.12 and 4.4.13). Given the growing spillover effects of the global turmoil in the first quarter of 2009, employment and real wages are expected to remain on a downward track.

Graph 4.4.12. Employment and Real Wages in Wholesale-Retail Trade Industry
(Seasonally Adjusted)

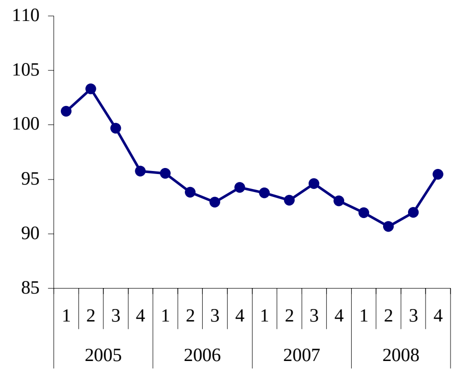
Source: TURKSTAT, CBRT.

Graph 4.4.13. Employment and Real Wages in Trade-Services Industry
(Seasonally Adjusted)

Source: TURKSTAT, CBRT.

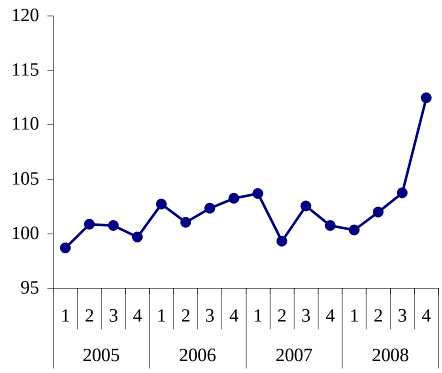
The question of how the outlook for real wages and employment translates into inflation should be discussed in two aspects: demand and costs. The fact that the negative trend in employment and unemployment rates would put pressure on total wages could have a dampening effect on expendable income and domestic demand. Therefore, amid problems in the labor market, domestic demand may provide an added support to disinflation. On the costs front, the rapid contraction in economic activity, driven by the sharp decline in total demand, appears to have hindered the effective use of resources by companies and reduced partial productivity. In fact, the drop in wages seems more moderate than the fall in output, which caused real wages to rise recently, particularly in the services industry (Graph 4.4.14 and 4.4.15). The continuation of low levels of total demand may require a downward revision to labor demand and wages. Moreover, in case of an earlier-than-expected recovery in demand conditions, increases in unit costs might be passed on to prices in the short run.

Graph 4.4.14. Real Unit Wages in Manufacturing Industry*
(Seasonally Adjusted, 2005=100)



* Value-added based.
Source: TURKSTAT, CBRT.

Graph 4.4.15. Real Unit Wages in Trade-Services Industry*
(Seasonally Adjusted, 2005=100)



* Value-added based.
Source: TURKSTAT, CBRT.

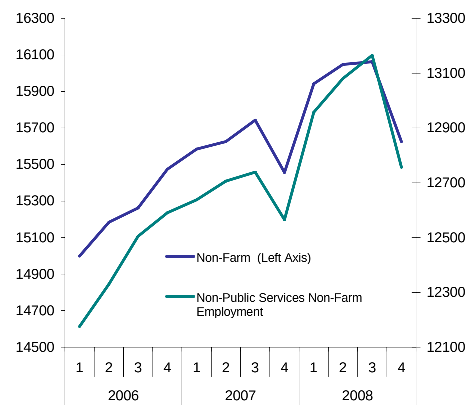
Box 4.1 MONITORING THE TRENDS IN EMPLOYMENT: DO WE NEED CORE MEASURES?

The mostly widely cited indicator of changes in the economic activity is non-farm employment. As in the derivation of core inflation measures, the aim in excluding farm employment is to better gauge the main course of employment, which is isolated from the general macroeconomic environment and excludes relatively external movements. To this end, it is essential that public sector-oriented employment movements, independent from the monetary stance, be excluded as well. Therefore, as in special CPI aggregates, employment would be better assessed by alternative measures that exclude developments in farm and public sector.

Previously, employment data from the TURKSTAT Household Labor Force Survey were released in two categories: public sector and private sector. The private sector employment data would involve “regular private sector” employment that excluded 5 sub-categories: *field, marketplace, street trading, non-established work place, and house*. Public employment data in the Household Labor Force Survey were previously compiled from answers of households who were interviewed, but since 2007, they are compiled from available data reported by other public institutions which is released by the Ministry of Finance. Apart from the changing data source, with the Address-Based Population Register System (ABPRS), downward revisions to indicators of population, labor force and employment prevented public employment series from qualifying as time series. Thus, in order to generate a new measure to gauge the main course of employment, we may exclude not only farm but also public employment-intensive economic activities.

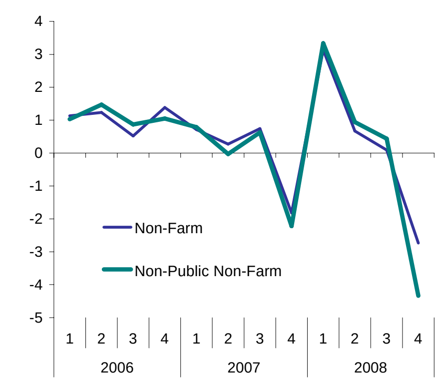
The public services industry is a highly public employment-oriented industry and can be regularly monitored in monthly terms. In the final quarter of 2005, 82 percent of employees in the public sector had been working in public services. Moreover, in that period public employment had accounted for about 70 percent of public services employment. Therefore, with the exclusion of public services from non-farm employment, we may derive a new measure similar to the regular private sector employment. In seasonally adjusted terms, the new series appears to have fallen at a more severe pace in the fourth quarter of 2008 than in non-farm employment (Graph 1 and Graph 2).

Graph 1. Non-Farm Employment and Non-Public Services Non-Farm Employment
(Seasonally Adjusted, Thousand Employees)



Source: TURKSTAT, CBRT.

Graph 2. Non-Farm Employment and Non-Public Services Non-Farm Employment
(Seasonally Adjusted, Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

Among sub-industries of public services, the main drivers of annual growth in non-farm employment were public administration, through 2007 and in early 2008, and education and health care services, by the second half of 2008 (Table 1). Excluding the contribution from public services, particularly education, non-farm employment expanded only slightly year-on-year in the final quarter of 2008. In addition, considering the low base from the fourth quarter of 2007, when the first turbulence hit the world and later evolved into a financial crisis, the 1.1 percent annual growth in non-farm employment appears to offer a more clouded outlook (Graph 1 and 2).

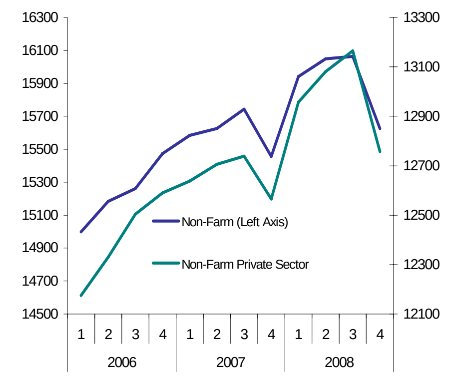
Table 1. Contributions to Yearly Non-Farm Employment Growth, Percentage Points

	Public Services	Public Management	Education Services	Health Care Services	Other	Non-Farm
07-1	0.5	0.4	0.2	0.2	-0.2	4.0
07-2	0.8	0.7	0.2	-0.2	0.0	3.0
07-3	1.4	1.5	-0.2	0.0	0.1	3.0
07-4	0.7	1.0	-0.1	-0.2	0.0	-0.1
08-1	1.2	0.8	0.3	0.1	-0.1	2.4
08-2	0.4	0.2	0.1	0.2	0.0	2.8
08-3	0.0	-0.3	0.2	0.2	0.0	2.0
08-4	0.9	-0.4	1.0	0.3	0.1	1.1

Source: TURKSTAT.

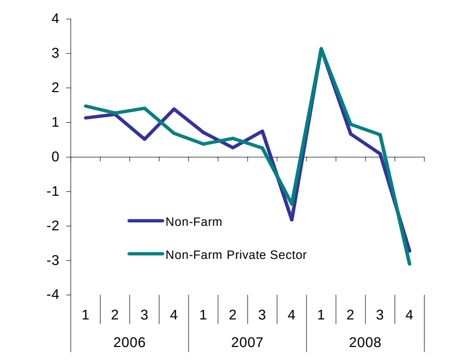
As a monthly indicator for public employment, public services employment provides invaluable information; however, the exclusion of public services inevitably causes loss of information regarding the behavior of private sector. Hence, CBRT takes into account the above restrictions about public employment in analyzing the economy and, in line with the ABPRS, associates the downward revisions to level-related variations, such as population, labor force and employment, with the data set compiled from public institutions and harmonizes them with the household data.[2] Excluding the so-generated public employment series from non-farm employment, the quarterly decline in the fourth quarter of 2008 appears to be higher in seasonally adjusted terms, compared to non-farm employment (Graph 3 and 4).

Graph 3. Non-Farm Employment and Non-Farm Private-Sector Employment
(Seasonally Adjusted, Thousand Employees)



Source: TURKSTAT, CBRT.

Graph 4. Non-Farm Employment and Non-Farm Private-Sector Employment
(Seasonally Adjusted, Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

In sum, the new measure that is based on non-farm private sector data and intended to better gauge the main trends in employment offers a gloomier fourth-quarter outlook than non-farm employment. In addition, although this core employment measure provides a better understanding of the main trends, due to its relations with financial conditions and expectations within conventional transmission channels, it should be born in mind that it is necessary to monitor disposable income with regard to domestic demand, and therefore total employment data are also important.

[2] The new population projections that were modified according to the Address-Based Population Register System (ABPRS) have been used by TURKSTAT in their labor force surveys since January 2009 without a backward revision. Therefore, as the Box analyzes the period between 2000 and 2008, new population projections are not taken into account; level-related variations – excluding proportional indicators such as sectoral weights and unemployment – are revised backwards, keeping the ABPRS-related downward revision to population.

5. Financial Markets and Financial Intermediation

5.1. Financial Markets

The financial crisis, which first erupted in the third quarter of 2007 in the US real estate market and spread globally by deepening further starting from the fourth quarter of 2008, continued into the first quarter of 2009. Although concerns about global financial fragility have eased, new data releases indicate that the financial turmoil may have a longer and deeper than expected impact on economic activity. Despite the recent slight recovery in leading indicators for advanced and emerging market economies, the implications of the crisis on global economy are yet to fade solidly.

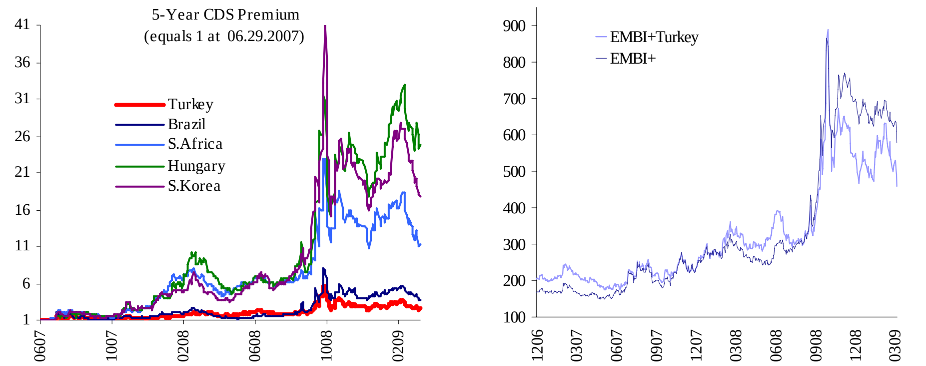
During this period, monetary and fiscal policy authorities continued to take remedy actions to counter problems in financial markets and stimulate economic activity. Accordingly, central banks in advanced economies have continued to implement unconventional monetary policy measures to accelerate liquidation of distressed assets off the balance sheets of troubled banks in order to ease credit conditions. Although the global liquidity shortage has been considerably eased, measures are yet to have a desirable impact on credit mechanisms. The massive loss encountered by the financial institutions during the financial crisis as well as the unpriced derivatives in their portfolios result in further reluctance of these institutions to extend credit.

Meanwhile, central banks in emerging economies have slashed policy rates at a faster-than-expected pace, intending to reduce the impact of the global crisis on economic activity. Countries such as Turkey, where financial markets are relatively more stable and the risk premium is less deteriorated, have benefited from greater room for monetary policy and been able to cut policy rates more aggressively (Box 5.1). Nevertheless, as global risk perceptions have not returned back to normal, additional tightening in credit conditions could not completely disappear.

Apart from central banks, fiscal authorities in most countries launched fiscal stimulus packages in the fourth quarter to help spur economic recovery and provide support to troubled industries. During the fourth quarter, countries have more evidently called for coordinated action to tackle the global crisis and major steps have been taken to incorporate emerging economies into the process.

Despite all the measures to alleviate the impact of the financial crisis on the financial system and economic activity, there are no visible signs that the crisis has ended. Thus, emerging market economies are still exposed to difficulties in reaching global capital markets through both portfolio and credit channels, and also face downward pressure on their economic activity due to adverse aggregate demand conditions. As a result, despite the slight recovery towards the end of the fourth quarter, risk premium indicators for emerging economies still remain elevated (Graph 5.1.1). On the other hand, the deterioration in Turkey's risk premium continues to remain relatively limited since the outbreak of the crisis.

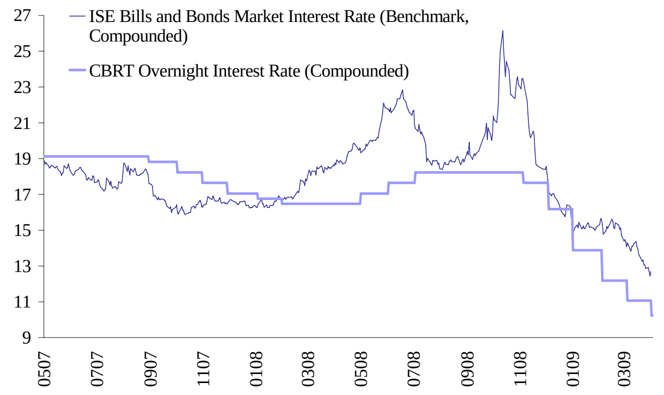
Graph 5.1.1. Risk Premium Indicators



Source: Bloomberg.

During the crisis period, Turkey, with its sound banking structure and relatively less deteriorated risk premium, decoupled from many emerging economies and was able to cut policy rates more aggressively. In view of the weakening aggregate demand, the continued tightening in credit conditions and the improved inflation outlook, the CBRT continued its policy rate cuts, which started in November 2008, into the first months of 2009, and total policy rate cuts have reached 700 basis points as of April. As the available data in that period substantiated CBRT's strategy of rapid rate cuts, market interest rates fell significantly (Graph 5.1.2). In addition to policy rate cuts, signs of further policy rate cuts and the recent slight recovery in risk perceptions accelerated the downward trend in market interest rates.

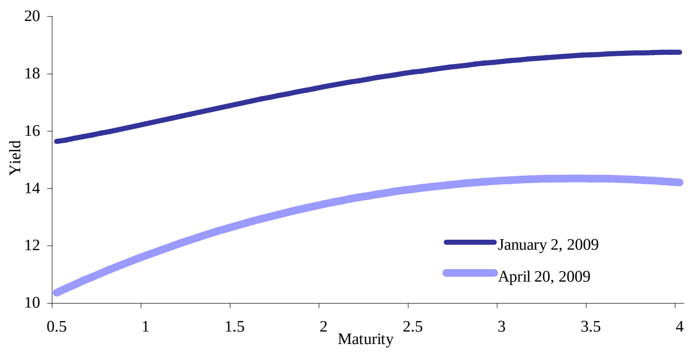
Graph 5.1.2. Changes in Interest Rates
(Percent)



Source: ISE, CBRT.

The sharp downward trend in market interest rates has been observed at every maturity. As a matter of fact, yields on April 20, 2009 dipped below those on January 2, 2009 in every maturity range. On the other hand, the negative slope of the long end of the yield curve points to stronger expectations for inflation to maintain its downward trend in the medium term (Graph 5.1.3).

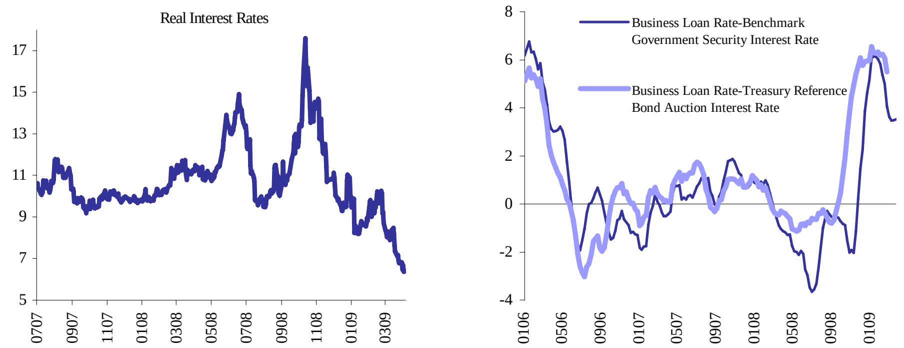
Graph 5.1.3. Yield Curves
(Percent)



Source: CBRT.

The downtrend in market rates spilled over into medium-term real interest rates and real market rates fell below their pre-crisis level (Graph 5.1.4). Real rates are likely to fall in well-functioning economies during times of recession, which, however, is quite unprecedented for Turkey. Therefore, the current level of real rates, compared to previous crisis episodes, is an indicator for the improved effectiveness of monetary policy. Nevertheless, despite the decline in real market rates, additional tightening in financial conditions prevails due to elevated credit risk perception. As a matter of fact, the spread between higher-risk business loans and lower-risk Treasury bond rates remains still high.

Graph 5.1.4. Medium-Term Real Interest Rates from the Yield on Government Securities* and Indicators for Tightened Business Loans Standards
(Percent)

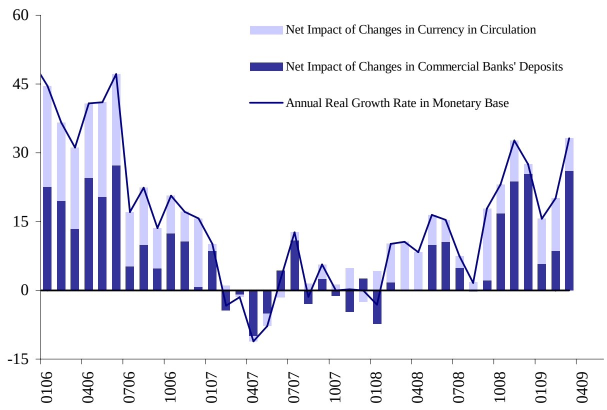


* 2-year real interest rates, calculated using 2-year nominal interest rates from the yield curve and inflation expectations from the CBRT's Expectations Survey.

Source: ISE, CBRT.

Despite the recent moderate recovery, uncertainties remained high during the first quarter, causing economic agents to move further away from high to low-risk assets. As a result, monetary base continued to grow in real terms (Graph 5.1.5).

Graph 5.1.5. Annual Real Growth of Monetary Base
(Percent)

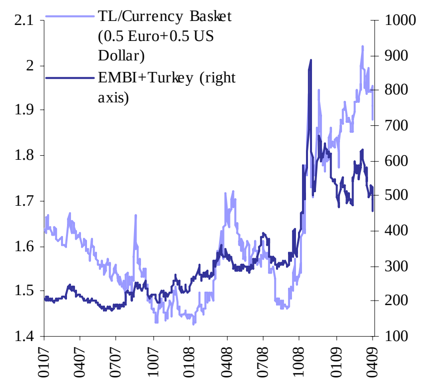


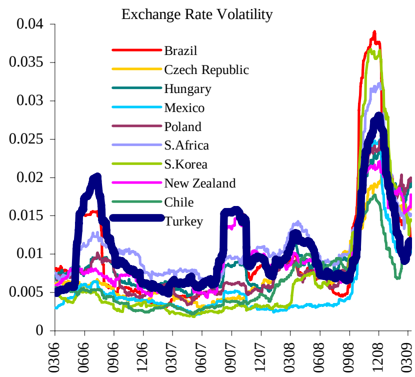
Source: CBRT.

Uncertainties about the world economy and financial system continued to exert pressure on the value of emerging market currencies in the first quarter. In terms of changes in currency values, the Turkish lira did not significantly differ from other emerging market currencies. However, the relative fall in the volatility of the Turkish lira, which had a historically high volatility and extreme sensitivity to global risk appetite, has become more evident in 2009, when countries' own experiences began to unfold following the worst period of the crisis (Graph 5.1.6).

As another highlight, countries that have lowered policy rates more aggressively have faced less depreciation in their currencies since the deepening of the global crisis in September 2008, which is due to the fact that changes in risk premiums during crisis play a major role in determining exchange-rate losses and monetary policy decisions. In plain terms, countries with relatively less increasing risk premiums during crisis have faced less depreciation in their currencies, and their central banks have been able to cut policy rates more aggressively. In the upcoming period, access to global capital is expected to remain tight, signaling further potential pressure on emerging market currencies.

Graph 5.1.6. Exchange Rate Changes

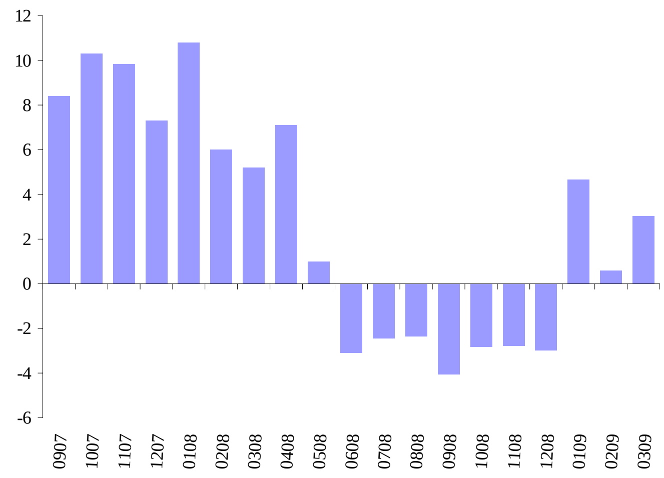




Source: CBRT.

The liquidity shortage in the market that started in mid-2008 was replaced slightly by excess liquidity in the first quarter of 2009 (Graph 5.1.7). The main driver of the excess liquidity was Treasury's reduced account balance at the CBRT, owing to the increased budget deficit. On the other hand, CBRT's currency selling auctions caused excess liquidity to decrease. During this period, the CBRT provided liquidity through regular 1-week repo auctions in cases of liquidity shortages or uneven distribution of liquidity in the market. The auctions were intended to provide efficient and stable functioning of money markets by preventing excessive volatility in short-term money market rates, and the amount of liquidity in repo auctions was determined so as to keep overnight rates close to CBRT's borrowing rate and help the overnight borrowing rate continue to function as the reference rate for monetary policy.

Graph 5.1.7. Excess TL Liquidity
(Monthly Averages, Billion TL)



Source: CBRT.

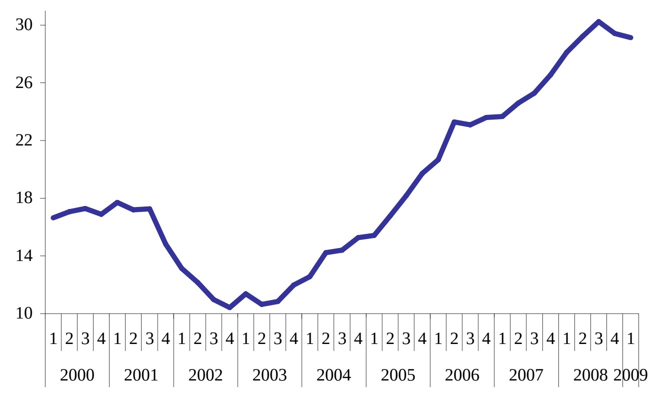
Against concerns about the potential adverse impact of the global financial turmoil on financial stability, the key prerequisite of price stability, the CBRT, in addition to its main objective of maintaining price stability, continued to pursue an active liquidity management in the first quarter of 2009. In view of the developments in international money market rates, the CBRT changed maturities and interest rates in the Interbank Foreign Exchange Deposit Market on February 20, 2009. Accordingly, the maturity of foreign exchange deposits offered to commercial banks was extended to 3 months and lending rates were reduced to 5.5 percent in US dollars and 6.5 percent in euros. Furthermore, the maturity of Interbank transactions in the Foreign Exchange Deposit Market was extended from 1 month to 3 months. Moreover, in order to avoid noncompetitive pricing in the foreign exchange market, on March 10, 2009, daily foreign exchange selling auctions amounting to 50 million US dollars were resumed. However, on April 3, 2009, in view of the improved conditions in global financial markets and waning concerns over the depth in the foreign exchange market, these auctions were suspended. In addition, albeit the soundness of the banking system and its resistance against any external shocks, conditions to grant Liquidity Support Credit to banks in cases of emergency were revised and corresponding rules and regulations were released on January 29, 2009.

In case of deepening of international market problems and emergence of their adverse effects on domestic financial markets, the CBRT will take further measures. Accordingly, additional yet minor cuts in foreign exchange reserve requirements ratio may be considered. During periods of diminishing depth in the foreign exchange market, foreign exchange purchase auctions may be resumed, and if noncompetitive pricing in the foreign exchange market is observed due to speculative behavior, direct intervention may take place. Furthermore, transaction limits in the Foreign Exchange Deposit Market may be raised, maturity of foreign exchange deposits offered to banks may be extended and interest rates may be lowered.

5.2. Financial Intermediation and Loans

The mounting uncertainty surrounding the global economy, coupled with economic slowdown, lead to a contraction in the domestic credit market. Recent developments in financial markets aggravate risk aversion, reducing the lending appetite of banks. Besides, weaker domestic demand and the uncertainty about the disposable income cause loan demand to decelerate (Box 5.2). Accordingly, the ratio of loans to national income continued to decline (Graph 5.2.1).

Graph 5.2.1. Real Sector Loans / GDP*
(Percent)



*Real sector loans are composed of household loans and business loans. Estimated figures are used for Reel 2009Q1 GDP.

Source: CBRT.

The decline in loan supply was largely driven by the uncertainty about external borrowing facilities and the increased credit risk fuelled by economic contraction. Ongoing problems in international credit markets restrict real sector's access to external financing facilities. Meanwhile, the economic recession leads to a likely rise in arrears for both corporate and household loans. More specifically, the increase in the rate of overdue debt in the recent period displays preliminary signs of a rise in loan arrears (Table 5.2.1). The increased perception of credit risk causes banks to stay cautious about lending. Thus, banks shift to liquid assets such as government securities, thereby restricting the credit supply. Moreover, the short maturity of deposits in addition to increased risk perceptions amid global uncertainties result in banks to avoid long-term lending.

Table 5.2.1 Overdue Debt
(QoQ, Percent)

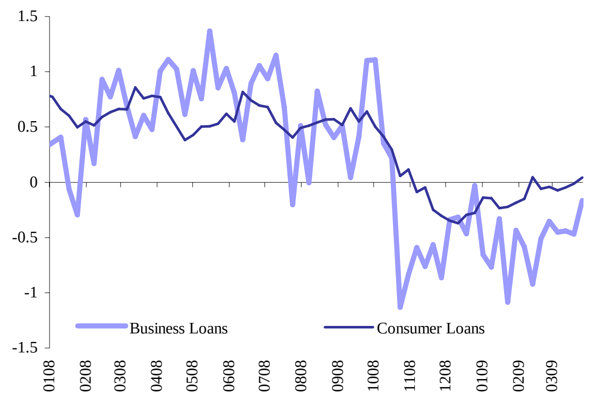
	Consumer loans	Housing Loans	Auto Loans	Other	Credit Cards	Business Loans
2008-I	1.54	0.71	4.50	1.89	6.59	3.45
2008-II	1.66	0.78	4.66	2.06	6.46	3.19
2008-III	1.78	0.90	4.60	2.21	6.35	3.15
2008-IV	2.25	1.15	5.95	2.82	7.17	3.51
2009-I	3.05	1.59	8.31	3.82	9.08	4.21

Source: CBRT.

On the demand side, the deterioration in expectations regarding the economic outlook and the decline in consumer confidence have adversely affected the demand for loans. In addition, the slowdown in investment and consumption expenditures curtails the need of private sector for new borrowing. Deteriorating expectations for an increase in disposable income and rising precautionary savings accompanied by the significant decline in employment also have a dampening impact on loan demand.

Recently, with partially lowered credit rates amid policy rate cuts, there has been some recovery in consumer loans and business loans (Graph 5.2.2).

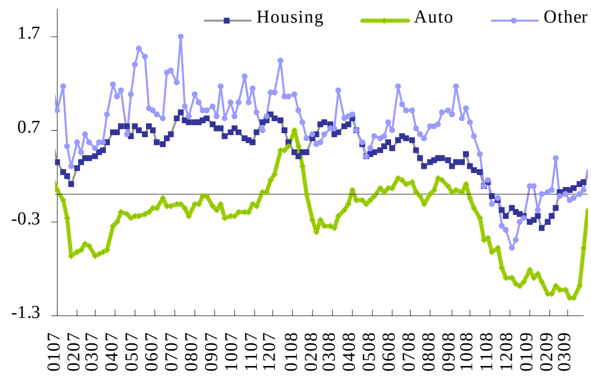
Graph 5.2.2. Business and Consumer Loans
(4-Week Moving Average, Percent)



Source: CBRT.

The analysis of sub-items of consumer loans reveals that housing and personal loans have recently increased at a modest rate, while the pace of decline in auto loans has decelerated remarkably after the Special Consumption Tax cut. Yet, the recovery is considered to be short-lived as inventories are about to dry up and the tax cut is temporary (Graph 5.2.3).

Graph 5.2.3. Sub-items of Consumer Loans
(Moving Average of Weekly Changes, Percent)



Source: CBRT.

After the upward trend in the fourth quarter of 2008, loan rates were back on a downward trend in the first quarter of 2009, owing to sharp policy rate cuts and partially improved risk perceptions. Recently, the ongoing downward monetary stance contributes to the decline in loan rates. Interest rates on housing and personal loans have fallen below their pre-turbulence level, while those on auto loans have returned close to their pre-turbulence level (Table 5.2.2).

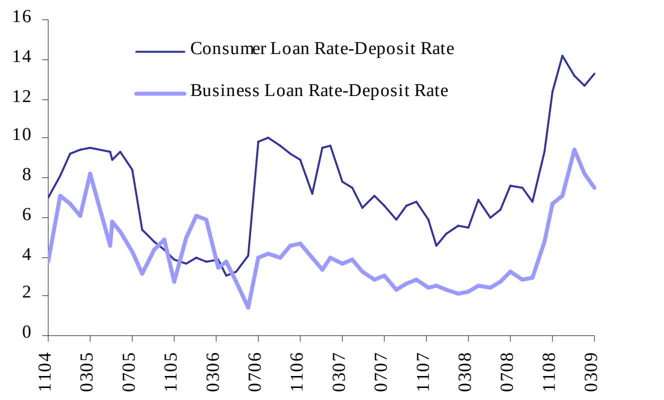
Table 5.2.2 Rates on Consumer Loans
(Monthly, Percent)

	10.03.08	12.12.08	04.03.09
Housing loans (120 months)	1.50	2.00	1.42
Auto loans (60 months)	1.70	2.11	1.76
Personal loans (36 months)	1.89	2.14	1.85

Source: Websites of selected commercial banks.

However, the spread between interest rates on deposits, the major borrowing instrument of banks, and loans remains elevated (Graph 5.2.3). This situation signals that additional tightening in financing conditions continues despite the decrease in loan rates.

Graph 5.2.4. Spread Between Loan Rates and Deposit Rates
(Compound, Percent)



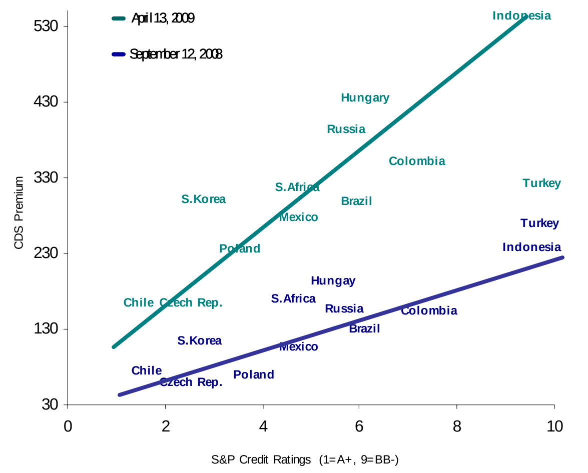
Source: CBRT.

To sum up, problems in the global economy and additional tightening in financial conditions persist. Although this has been partially compensated by recent policy rate cuts, domestic credit expansion is not expected to gain momentum in the upcoming period, under the assumption that access to external finance will be limited and economic agents will remain prudent.

Box 5.1 CHANGES IN THE RISK PREMIUM FOR EMERGING MARKETS AND POLICY RATE DECISIONS

The financial crisis that erupted in advanced economies deepened further in September 2008 and spread across the whole global financial system, leading to a dramatic increase in the risk premium for emerging markets. In general, the deterioration in risk premiums is more evident in countries with poor credit ratings. However, the situation is quite the opposite in Turkey. In this period, the risk premium for Turkey, one of the emerging economies with the poorest credit ratings, deteriorated only slightly. In other words, Turkey's risk premium has been much more resistant to deteriorated risk perceptions than implied by its credit rating. Therefore Turkey has been largely isolated from the relationship that is observed in most emerging economies between risk premiums and credit ratings (Graph 1). This observation indicates that traditional tools to measure credit ratings and risks are unlikely to be adequate for measuring the de facto credit risk in times when countries' own experiences unfold.

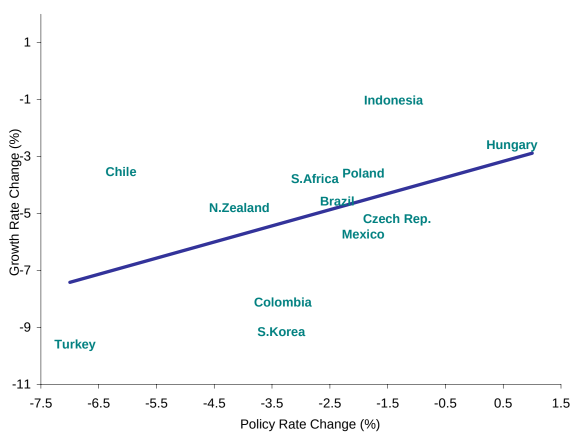
Graph 1. Relationship Between CDS Rates and Credit Ratings



Source: Bloomberg, CBRT.

With the deepening of the global economic crisis, commodity prices fell and global economic activity slowed, easing fears of inflation and thus enabling central banks to focus on financial stability and on the direction of economic activity. In order to dampen the impact of the global crisis on economic activity, central banks in advanced

Graph 2. Policy Rate Decisions and Growth*
(as of April 16, 2009)

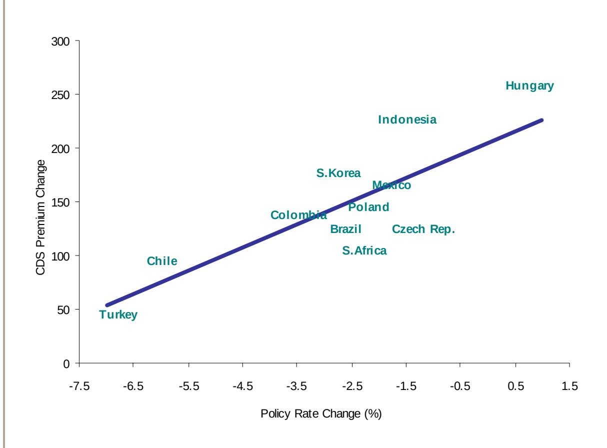


*The spread between annual growth rates in Q42008 and Q42007.
Source: Bloomberg, CBRT.

economies cut policy rates, while central banks in countries with sharper economic contraction cut policy rates more aggressively (Graph 2). Turkey, being one of those countries, ranked among emerging economies with the most aggressive policy rate cuts.

Meanwhile, central banks have also taken into consideration the changes in risk premiums before deciding on policy rate cuts. Accordingly, countries with relatively lower increase in risk premium have benefited from a broader room for monetary policy and been able to cut policy rates more aggressively. With its sound financial structure unlike most other emerging economies and relatively less deteriorated risk premium during the crisis, Turkey has been able to cut policy rates at a dramatic pace (Graph 3).

Graph 3. Policy Rate Decisions and Changes in Risk Premiums (As of April 16, 2009)



Source: Bloomberg, CBRT.

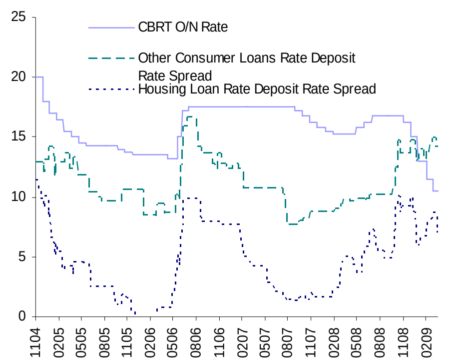
Box 5.2 GLOBAL CRISIS AND FINANCIAL INTERMEDIATION

In an economy that is vulnerable to negative shocks; the financial position of the real sector deteriorates, its current ability to pay weakens and uncertainties about its future ability to pay rise. Country experiences suggest that, under such circumstances, financial intermediaries that channel funds into the real sector become more cautious in lending, thus leading to rising interest rates and/or tightening credit conditions. It is also commonly observed that the aforementioned stance of financial intermediaries is translated into downward pressure on economic activity, which adds to the slowdown in the economy. This conjuncture-based mechanism is known as “financial accelerator” in the literature. A similar picture has been observed in the recent global crisis, with the financial accelerator mechanism being solidly evident both globally and in Turkey.

Due to the global crisis, access to foreign funds has become more restricted, and the foreign demand for domestic goods has waned with spillovers into the real sector, which caused production to shrink and revenues to drop. In 2008, the CBRT adopted a series of measures to prevent banks from running into liquidity squeeze, and consequently began to cut policy rates aggressively as of November. On the other hand, unlike policy rates, credit rates have not decelerated, and credit volume has followed a downward trend since the fourth quarter of 2008.

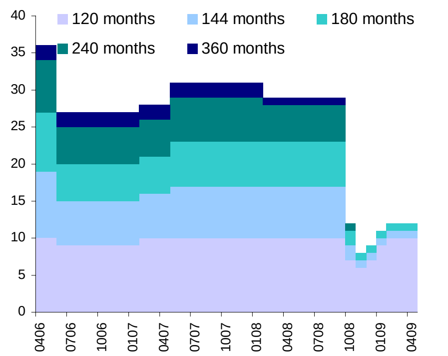
For a better understanding of financial intermediaries' attitude towards credits and decomposing the supply side and demand side factors in credit volume movements, different measures are necessary other than credit volume. Graph 1 shows the spread between the rates on deposits and loans for top banks in terms of their asset size in the banking system.[1] The spread between loan and deposit rates provides information on default risk, maturity mismatch risk and restrictions relating to the source of financing for banks. As it is shown in Graph 1, amid heightened uncertainty (second quarter of 2006 and second half of 2008) the gap between "loan rates–deposit rates" widens. Historical series for the spread between rates on housing loans and personal loans with the same maturity follow the same pattern as the series for overdue housing loans and personal loans (Table 5.2.1). This indicates that the default risk explains part of the gap between deposit and loan rates.

Graph 1. Spread Between Loan Rates and Deposit Rates*



*Deposit rate is the median 3-month deposit rate offered by major banks. Likewise, median 60-month housing rate median 12-month personal loan rate have been used.
Source: CBRT, TURKSTAT.

Graph 2. Total Number of Banks That Offer Housing Loan Quotes For At Least 10 Years*



*Total number of long-term housing loans announced by relatively large banks.
Source: CBRT.

Long-term loans (10 years and above) account for about 8 percent of the housing loans offered by banks. Although this ratio seems to be relatively small, long-term housing loans offered by banks with the largest share in the system give insight into the banks' attitudes towards lending. As it is known, with the launch of the Mortgage System, banks added longer-term housing loans into their portfolios. The number of banks offering long-term housing loans[2] dropped in times of heightened

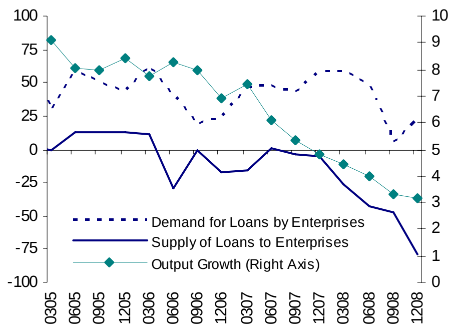
[1] Median value.
[2] Maturities announced by commercial banks on their websites.

uncertainties. As Graph 2 illustrates, this situation has occurred immediately after the turbulence in June 2006 and more evidently during the fourth quarter of 2008. This attitude is considered to be an indicator of banks' perceptions of maturity mismatch risks and/or the financing difficulties that the banks encounter.

The "Banks' Loans Tendency Survey", which is conducted by the CBRT to monitor loan tendencies, contains important additional qualitative data to previous inferences from quantitative data. The survey is conducted among major banks that provide more than 80 percent of the total loans in the banking sector and asks questions about both loan standards and loan demand, which helps to decompose supply and demand factors that drive credit dynamics.[3]

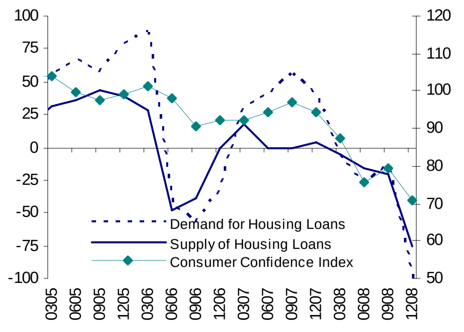
Results from the survey support the above results of the quantitative data. As it is shown in Graphs 3 and 4, with the slowdown in the pace of growth amid the increased uncertainty, banks tighten their standards on both housing and business loans. The tightening in loan standards was much severe after the outbreak of the global crisis in 2008 than that following the financial turbulence in 2006.

Graph 3. Tightening in Business Loan Supply*



*Positive/negative values denote easing/tightening in supply and rise/fall in demand.
Source: CBRT, TURKSTAT.

Graph 4. Tightening in Home Loan Supply*

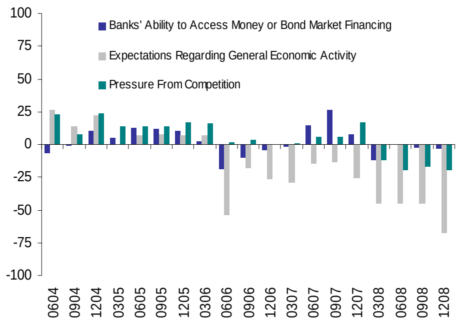


* Positive/negative values denote easing/tightening in supply and rise/fall in demand.
Source: CBRT.

[3] The change in the direction of credit demand and supply can be captured by the quantification of qualitative response using net percentage change. For credit standards, the net percentage change is calculated as (somewhat eased+considerably eased)-(somewhat tightened+considerably tightened). For credit demand, the net percentage change is calculated as (somewhat higher+considerably higher)-(somewhat lower+considerably lower).

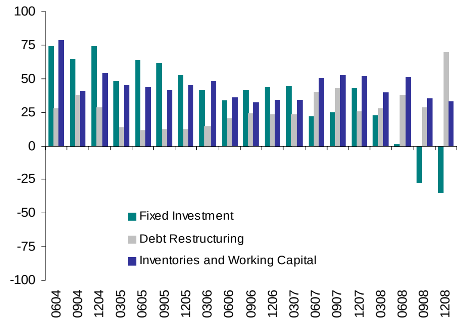
As stated before, the deterioration in credit conditions may result not only from default and maturity risks, but also from restrictions on financing sources. The liquidity facilities offered by the CBRT may fail to fully substitute the funds that banks had already used, adding to the tightening in loan standards and conditions. The survey results in Graph 5 show that, although such restrictions had affected credit conditions in 2006, banks did not mention any liquidity and capital restrictions among factors affecting business loan standards in 2008. The survey results also indicate that, recently, it has been not the banks' own restrictions but their risk perceptions about the economy that underlie the tightening in loan standards.

Graph 5. Factors Affecting the Supply of Business Loans*



* Positive/negative values denote easing/tightening in supply and rise/fall in demand.
Source: CBRT.

Graph 6. Factors Affecting the Demand for Business Loans*



*Positive/negative values denote easing/tightening in loan demand.
Source: CBRT.

In times of mounting uncertainties, investment loans are expected to remain flat or even decline. However, at the onset of the contraction, if the fall in demand triggers a subsequent drop in production with a certain lag, the increased need to finance inventories may prompt businesses to find more funds. Moreover, wage payments that only decline with a lag and interest payments on the current debt stock may prompt businesses to resort to external financing due to reduced cash flows. Previous experiences have shown that consumer confidence tends to decline in such periods, having an adverse impact on the demand for consumer loans. The findings from survey results regarding loan demand confirm the above projection. Graph 3 shows that the demand for business loans has continued to increase, albeit at a gradually slower pace, since the onset of the economic downturn in the first quarter of 2008. Graph 4, on the other hand, shows that the demand for housing loans has fallen in line with declining growth trends and diminishing consumer confidence. According to Graph 6, which shows factors affecting the demand for business loans individually, the loan demand for fixed investments dropped dramatically in the second half of 2008. The demand for business loans was still on the rise even during the deepening contraction in the final quarter of 2008, largely due to rising inventories and the need for more business capital. Business debt restructuring has been another driver of the demand for business loans. Companies facing limited cash flow chose to restructure their debt under better terms, which, again, is closely related to the above projections. Graph 6 also shows that the strong demand for domestic goods in 2006 had reduced the negative effect from the uncertainty surrounding financial markets in the second quarter of 2006. Given the tightening credit supply during that period, the need for more business capital and/or debt restructuring did not spur loan demand, as companies did not face a serious decline in cash flow.

Survey results regarding the demand for business loans are also consistent with other data. According to CBRT's Business Tendency Survey, "the stock level of available finished goods" increased during the marked economic downturn in 2008 but began to fall after the fourth quarter. According to the "Short-Term Business Statistics" released by TURKSTAT, labor payments did not decline at the same pace with production.

In sum, during the economic contraction, the financial system in Turkey has followed the same pattern as in other advanced and emerging market economies with regard to the additional tightening in credit conditions, adding to the contraction as in most countries. Household loan demand for consumption purposes and business loan demand for investment purposes dropped independently from credit supply conditions; but as the economic recession crept slowly in, business loan demand increased amid reduced cash flow and rising need for debt restructuring, which indicates that the additional tightening in credit conditions began to have a negative impact on current production. Under such circumstances, measures to provide companies with access to loans under better terms are likely to ease problems in current production thus having a positive effect on prices as well.

6. Public Finance

Countercyclical fiscal measures, designed to dampen the impact of the marked slowdown in global growth and the financial crisis, lead to a sharp rise in budget deficits in 2009 (Table 6.1). In Turkey, public sector budget deficit widens rapidly in line with global economic trends. The economic contraction since the fourth quarter of 2008 has a negative effect on tax revenues, particularly in consumption taxes. Moreover, fiscal measures that have been adopted to contain the spillovers from the global crisis and to stimulate domestic demand put strain on public budget balance.

Table 6.1. Public Sector Budget Balance
(In percent of GDP)

	2007	2008	2009*	2010*
G-20	-1.1	-2.6	-5.9	-6.3
Advanced Economies				
UK	-2.7	-5.5	-9.5	-11.0
United States	-2.9	-5.9	-7.7	-8.9
France	-2.7	-3.1	-6.0	-6.2
Germany	-0.2	-0.1	-4.0	-5.2
Italy	-1.5	-2.7	-4.8	-5.2
Japan	-3.4	-5.0	-8.1	-8.3
South Korea	3.8	1.2	-2.2	-3.2
Emerging Economies				
Argentina	-2.3	-0.5	-3.6	-2.3
Brazil	-2.2	-1.5	-1.0	-0.8
China	0.9	-0.3	-3.6	-3.6
India	-5.2	-8.4	-10.0	-8.6
Mexico	-1.4	-1.9	-3.2	-2.9
Russia	6.8	4.2	-5.2	-5.1
South Africa	0.9	-0.1	-2.7	-3.4

* Forecast.
Source: IMF (2009), "Global Economic Policies and Prospects", G-20 Meeting of the Ministers and Central Bank Governors, March 13-14, 2009, London, UK.

Most countries, including Turkey, have recently adopted countercyclical fiscal measures to reduce the impact of the global crisis on economic activity. In order to boost domestic demand, Turkey lowered the resource utilization support fund (RUSF) on consumer loans from 15 percent to 10 percent and cut the VAT and special consumption tax (SCT) on certain goods for 3 months. In addition, loans extended to manufacturing or exporting small and medium-sized enterprises were increased, the terms of borrowing were eased, and the cost of borrowing was reduced. Accordingly, the textiles industry was enabled to have increased access to borrowing facilities under better terms, the amount of KOSGEB (SME Development Organization) and Eximbank loans were increased, with easier repayment terms, and the repayment terms for loans extended to the agricultural industry by the Ziraat Bank and the Agricultural Credit Cooperatives were also eased. In order to support the production capacity of the economy, the amount and duration of short-term unemployment benefits were increased, and the employment for youth and women was promoted.

Not only spending measures, which are adopted to reduce the effect of the global crisis, but also the economic contraction affect budget balance. With the drop in consumption expenditures since the third quarter of 2008, SCT and VAT revenues, which account for a major share of central government budget revenues, began to fall. Moreover, the marked decline in imports has an adverse impact on tax revenues. The economic downturn does not only put pressure on tax revenues but also encourage capital transfers from the central government budget. In other words, the fall in employment leads to an additional drop in income tax revenues and puts downward pressure on revenues from social security premiums, thereby accelerating the capital transfers into the Social Security Agency.

Turkey has some room to implement countercyclical fiscal policies, thanks to the current structure of the public sector and the level of public debt. Yet, it is extremely important to be strongly committed to the medium-term budget discipline in order to fully benefit from the fiscal stimulus packages. As Turkey has a shorter average maturity of public debt and is relatively less developed in financial terms, a transparent fiscal framework is needed to promote further fiscal discipline in the medium term. The Pre-Accession Economic Program (PEP) announced in April is considered as a step forward. The renewed program for Turkish economy includes revisions to public fiscal targets for the 2009-2011 period. According to the renewed program, the ratio of government primary surplus to GDP is expected to fall from 4.1 percent in 2008 to 1.7 percent in 2009, and be around 2.6 percent in 2010 and 2011. Similarly, the ratio of government debt requirement to GDP is expected to rise from 1.5 percent in 2008 to 4.6 percent in 2009, and then fall again to 3.2 and 2.8 percent in 2010 and 2011, respectively.

In sum, budget revenues are likely to drop further in 2009 amid economic contraction, while government spending is expected to increase significantly year-on-year due to countercyclical fiscal policies. Thus, the steep increase in public sector debt requirement in 2009 may dampen the positive effect of monetary policy decisions on economic activity. In the current economic environment, budget deficits expand across all nations. Therefore, the short-term expansion in the budget deficit needs to be offset by a strong fiscal framework that restores a balanced fiscal position and maintains debt sustainability over the medium term.

6.1. Budget Developments

The sharp increase in central government budget expenditures and the drop in tax revenues were the main drivers of the poor budget performance in the first quarter of 2009. Central government budget expenditures rose sharply during January-March 2009 on rising interest expenditures, which were up 31.6 percent due to the substantial domestic debt redemption in February. As another factor that drove central government budget expenditures higher, non-interest expenditures increased by a stunning 27.8 percent in the first quarter, largely due to the 38.1 percent rise in current transfers, which account for the largest share of non-interest expenditures. Although transfers to finance the social security deficit during January-March 2009 were unchanged from a year earlier, current transfers for health, pension and social insurance funds grew by 48.7 percent, owing to the Treasury’s obligation to pay 5 percent of the employer’s share of social security premium since October 2008 and the government transfers to the Social Security Agency since November 2008. Furthermore, the economic contraction caused the revenues from social security premiums to fall, leading to an increase in current transfers. Infrastructure investments to enhance the production capacity of the economy and resource allocations for reducing labor costs have been other key factors that boosted central government primary budget expenditures.

Central government budget revenues grew by 0.2 percent year-on-year during January-March 2009. Tax revenues dropped by 5.2 percent, while non-tax revenues increased by 42.9 percent,. The significant growth of non-tax revenues was driven by the capital transfer of TL 1.3 billion from the Unemployment Fund to the general budget in February. Taxes on income and profits and on property were up 5 and 4.3 percent, respectively, whereas VAT on imports, special consumption tax and domestic VAT, all indirect taxes, fell by 30.7, 7.6 and 1.5 percent, respectively. Accordingly, the central government primary budget balance and the central government budget balance posted a deficit of TL 1 billion and TL 19.1 billion, respectively, in the first quarter of 2009 (Table 6.1.1).

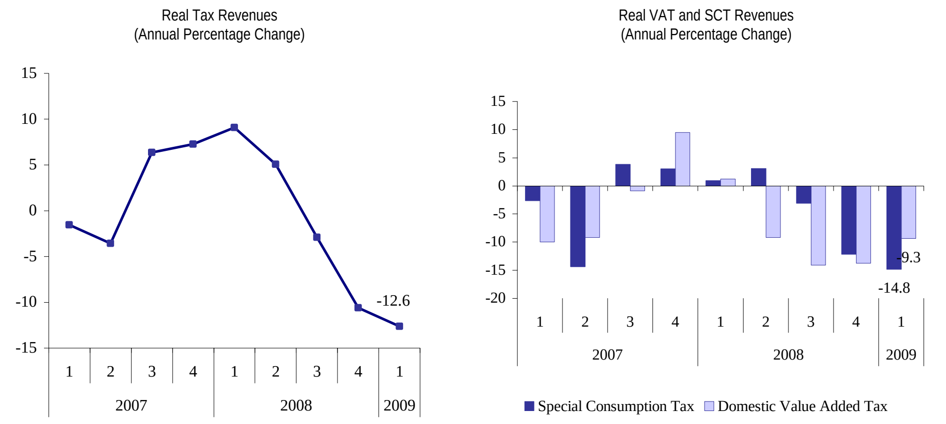
Table 6.1.1. Central Government Budget Aggregates
(Billion TL)

	January-March 2008	January-March 2009	Rate of increase (%)	2008 January-March Realization/ Budget target (%)	2009 January-March Realization/ Budget target (%)
Central Government Expenditures	**51.56**	**66.42**	**28.8**	**23.2**	**25.6**
A) Interest Expenditures	**13.75**	**18.09**	**31.6**	**24.6**	**31.5**
B) Non-Interest Expenditures	**37.81**	**48.33**	**27.8**	**22.7**	**24.0**
I. Personnel expenditures	12.51	14.50	15.9	25.7	25.3
II. Government premiums to social security agencies	1.59	1.77	11.6	24.8	24.4
III. Purchase of goods and services	3.78	4.80	27.0	16.5	18.9
IV. Current transfers	17.51	24.18	38.1	25.3	27.5
V. Capital expenditures	0.93	1.11	19.3	7.9	7.5
VI. Capital transfers	0.55	0.39	-29.1	26.2	13.7
VII. Lending	0.94	1.59	68.7	24.0	34.1
VIII. Contingency appropriation	0.00	0.00	-	0.0	0.0
Central Government Revenues	**47.19**	**47.30**	**0.2**	**23.1**	**19.0**
A) General Budget Revenues	**45.33**	**45.44**	**0.2**	**22.7**	**18.7**
I. Tax revenues	40.26	38.14	-5.3	23.5	18.9
1. Taxes on income and profits	12.82	13.46	5.0	24.4	20.6
2. Taxes on property	1.64	1.71	4.3	40.6	35.4
3. Domestic taxes on goods and services	15.78	15.19	-3.7	22.1	19.2
4. Taxes on international trade and transactions	7.73	5.45	-29.5	23.1	13.0
II. Non-tax revenues	5.07	7.25	42.9	18.0	17.7
1. Enterprise and ownership revenues	1.02	1.23	20.7	27.1	16.6
2. Grants and aids received and special revenues	0.23	0.36	57.6	54.0	38.2
3. Interest, shares and fines	3.79	4.32	14.0	24.3	22.3
4. Capital revenues	0.04	1.34	3424.2	24.7	10.2
B) Revenues of Special-Budget Administrations	**0.93**	**1.01**	**8.8**	**23.2**	**26.0**
C) Revenues of Regulatory and Supervisory Agencies	**0.93**	**0.85**	**-8.4**	**24.6**	**44.4**
Budget Balance	**-4.37**	**-19.13**	-	**22.7**	**184.0**
Primary Balance	**9.38**	**-1.04**	-	**25.7**	**-2.2**

Source: Ministry of Finance.

The economic contraction that started in the third quarter of 2008 has deepened further recently, and in real terms, tax revenues decreased by 12.6 percent year-on-year in the first quarter of 2009. The real contraction in SCT and domestic VAT, which are mostly consumption-related taxes, amounted to 14.8 and 9.3 percent, respectively (Graph 6.1.1), indicating that the third-quarter decline in consumption expenditures continued into the first quarter of 2009.

Graph 6.1.1. Real Tax Revenues

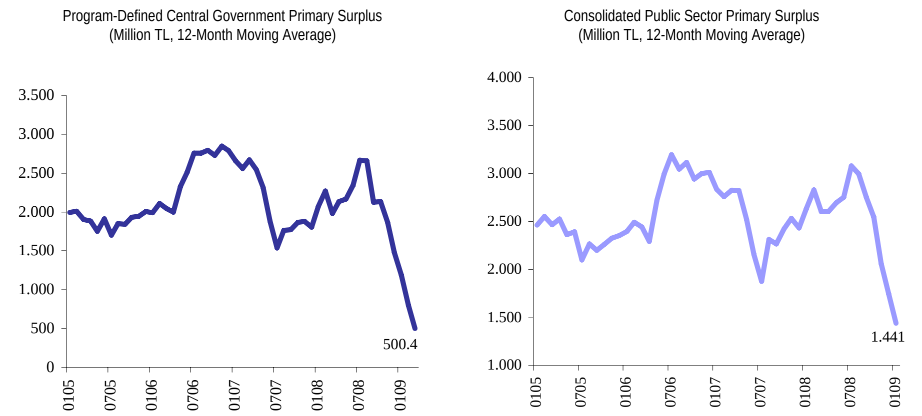


Source: Ministry of Finance.

Source: Ministry of Finance.

The public-sector primary surplus performance has been weakening since September 2008 (Graph 6.1.2). Unless an additional measure is taken, the poor performance is likely to continue into the fourth quarter of 2009. According to 12-month moving averages, both the program-defined central government primary surplus and the consolidated public sector primary surplus have fallen in the earlier months of 2009 back to their lowest levels in recent years.

Graph 6.1.2. Primary Surplus



Source: Treasury.

Source: Treasury.

The economic outlook clouded by the global financial crisis has prompted the whole world, including Turkey, to revise the macroeconomic framework and public finance projections. The PEP announced in April includes revisions to the ratio of central government budget targets to GDP in major categories, based on first-quarter realizations and the trends in expenditures and revenues for the remainder of the year. Accordingly, the ratio of central government primary surplus to GDP is expected to fall from 3.5 percent in 2008 to 1 percent in 2009.

With the acceleration in central government primary budget expenditures starting from the third quarter of 2008, public investments and public spending made a markedly positive contribution to GDP growth during the second half of 2008. Central government primary budget expenditures continued to accelerate in the first quarter of 2009. The budget targets revised by the PEP anticipate a rapid slowdown in central government primary budget expenditures for the remainder of 2009. Based on these assumptions, the contribution from public spending to GDP growth is expected to decline during the rest of the year. Accordingly, our medium-term forecasts in the final chapter of this Report are built on the projection that public spending will provide less support for the economy in the remainder of 2009.

The Medium Term Fiscal Framework that was adopted in 2007 targeted a primary surplus of 3.5 percent of GDP for 2008. Yet, the consolidated public-sector primary surplus, which accounts for a major share of the total public-sector primary surplus, amounted to 2.2 percent of GDP at end-2008 (Table 6.1.2). In view of the deterioration in the primary surplus performance of the non-consolidated public sector during the final quarter of 2008, the total public-sector primary surplus is considered to have failed to meet its 2008 target.

Table 6.1.2. Program-Defined Consolidated Public Sector
(Cumulative, Billion TL)*

	2005	2006	2007	2008	January 2009
Realizations					
Primary Balance	**28.3**	**36.2**	**29.2**	**21.0**	**0.4**
Central govt. budget	24.1	33.5	21.7	17.7	0.7
Overall Balance	**-4.2**	**-1.2**	**-10.0**	**-18.8**	**-2.7**
Central govt. budget	-11.5	-6.9	-20.7	-27.3	-3.0
Realizations in Percent of GDP					
Primary Balance	**4.4**	**4.8**	**3.5**	**2.2**	
Central govt. budget	3.7	4.4	2.6	1.9	
Overall Balance	**-0.6**	**-0.2**	**-1.2**	**-2.0**	
Central govt. budget	-1.8	-0.9	-2.5	-2.9	

* Figures for 2009 are provisional.
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 Fund.
Overall Government = Consolidated Public Sector + Local Administrations + Revolving Funds + Non-CGS SEEs.
Source: Treasury.

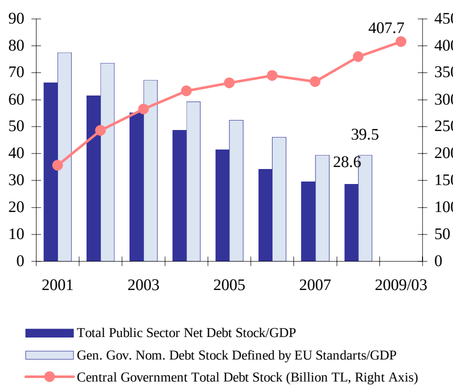
6.2. Developments in Debt Stock

Higher primary surplus targets that were set out in the fully implemented tight fiscal framework of the past few years and were achieved to a large extent have been the main driver of the substantial improvement in public debt indicators. However, both the economic contraction and the countercyclical fiscal measures adopted to dampen the impact of the global crisis on the economy weakened the budget performance and caused total public primary surplus to fall sharply starting from the fourth quarter of 2008. Assuming that the downtrend will continue through 2009, public debt indicators are likely to deteriorate in the upcoming period and the increased need for financing will put strain on borrowing costs.

The central government debt stock increased by 7.2 percent to 407.7 billion Turkish liras in March 2009 from end-2008. Net domestic debt growth, exchange rate movements and net foreign debt growth accounted for TL 15.1, 14.4 and 0.6 billion, respectively, of the TL 27.5 billion rise in the central government debt stock, whereas changes in parities reduced the debt stock by TL 2.5 billion. Meanwhile, despite some rebound in the fourth quarter, the ratio of net total public debt stock to GDP fell to 28.6 percent year-on-year in 2008, maintaining the downward trend of the past few years. In addition, the ratio of EU-defined central government nominal debt stock to GDP remained unchanged from 2007 and equaled 39.5 percent (Graph 6.2.1). According to the Medium Term Fiscal Framework introduced in 2007, the ratio of EU-defined central government nominal debt stock to GDP is forecasted to be 35 percent in 2008. Moreover, with the expectation that the public sector primary surplus will fall sharply and the pace of economic growth will decelerate dramatically in 2009, public debt stock ratios are likely to rise substantially.

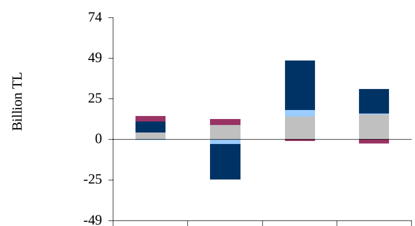
Graph 6.2.1. Public Debt Stock Indicators

Public Debt Stock Indicators



Source: Treasury, CBRT.

Decomposition of the Change in Central Govt. Debt Stock

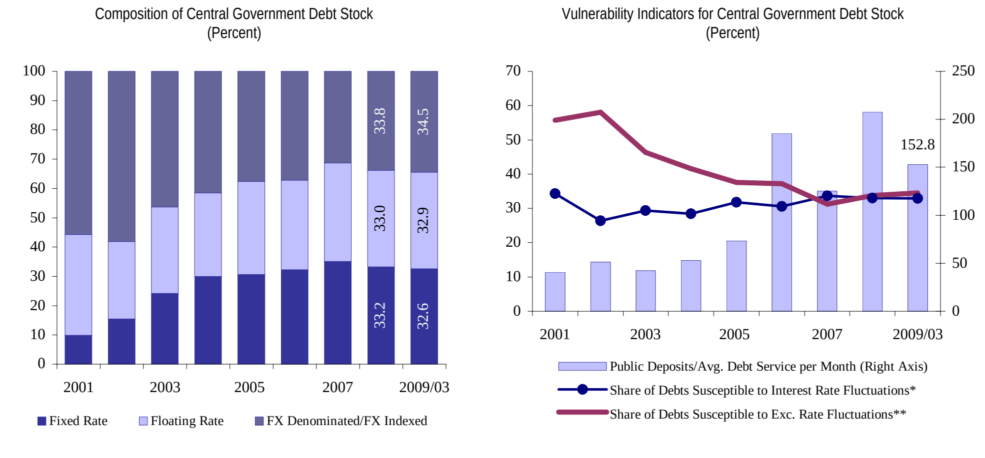


	2006	2007	2008	2009/03*
Parity Effect**	3.2	3.4	-1.0	-2.5
Tot. Exc. Rate Effect***	6.4	-21.2	29.9	14.4
Net External Borrowing	-0.5	-2.6	4.0	0.6
Net Domestic Borrowing	4.5	8.9	13.9	15.1

* Changes compared to end-2008.
** Changes arising from movements in USD/EUR and USD/SDR parities.
*** Changes arising from movements in the TL/USD parity.
Note: Changes in net debt denotes the change adjusted for the exchange rate and parity effect.
Source: Treasury, CBRT.

In March 2009, the share of fixed-rate instruments in central government debt stock decreased compared with end-2008, while the share of exchange-rate sensitive (FX-denominated and FX-indexed) instruments increased (Graph 6.2.2). With the debt and risk management policies that have been implemented as part of the 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 March 2009 at 34.5 percent due to the upward shift in exchange rates during subsequent periods. 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.

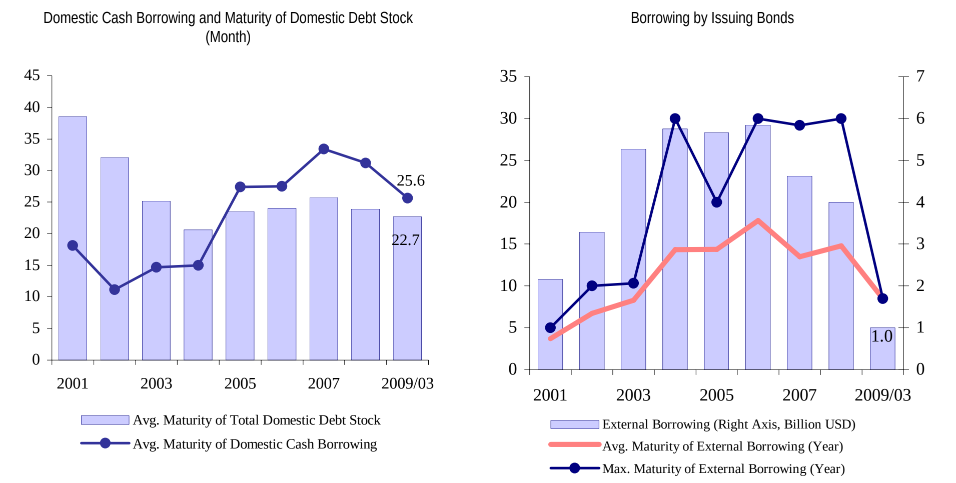
Graph 6.2.2. Structure of Central Government Debt Stock



* Debt stock sensitive to interest rates contains discounted securities with a maturity less than 1 year and government securities with flexible interest rates.
** Debt stock sensitive to exchange rates contains foreign debt stock and FX-denominated and FX-indexed domestic debt stock.
Source: Treasury, CBRT.

Following the financing strategy intended for reducing the liquidity risk, the ratio of public deposits to average monthly debt service ended March 2009 at 152.8 percent (Graph 6.2.2). The average maturity of domestic cash borrowing was down from the 2008 average, causing the average maturity of total domestic debt stock to fall to 22.7 months in March 2009. Moreover, bond issues yielded a USD 1 billion worth of long-term foreign debt in March 2009 with an average maturity of 8.5 years (Graph 6.2.3).

Graph 6.2.3. Maturity of Borrowing from Domestic and Foreign Markets



Source: Treasury, CBRT.

With the increased public financing requirement in 2009, the domestic debt rollover ratio is expected to increase rapidly from 2008, which will put some pressure on the downward spiral in medium-term market rates and is likely to reduce the positive effects of the monetary easing since November 2008. Therefore, a strong fiscal framework that maintains debt sustainability over the medium term will be highly accommodative for containing the spillovers from the global crisis.

7. Medium-Term Projections

This Chapter summarizes the assumptions underlying forecasts, and presents relating medium-term inflation and output gap forecasts and the monetary policy outlook. It is believed that the greatest risk for the upcoming period remains the uncertainty over the impact of the global financial turmoil on the real economy and the timing of the recovery in the global economy. Therefore, as the medium-term outlook for inflation and monetary policy will continue to largely depend on the developments in the global economy, in order to enhance the predictability of monetary policy we decided to present an alternative scenario, in which the recovery in the global economy starts later compared to the baseline scenario. 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 January 2008 Inflation Report and compiled from the information, analyses and expertise presented in previous chapters.

The sharp contraction in global economic activity and its larger than anticipated impact on domestic activity has led to the downward revision of the outlook envisioned in the previous Report. In the January Inflation Report, output was expected to display a significant decline in the last quarter of 2008, while it was anticipated that the speed of contraction would start to lose pace during the first quarter of 2009. In line with expectations, GDP displayed a sizeable drop in the last quarter of 2008, both in quarterly and yearly terms. Furthermore, coincident indicators of economic activity suggest that the contraction in GDP during the first quarter of 2009 was significantly larger than foreseen in the previous Report. This development was the main reason behind the downward revision to the outlook for inflation and monetary policy. The continued downward revision to the global economic outlook has been another development that affected medium-term forecasts.

With the sharper economic downturn and the reversal of cost pressures, the downtrend in inflation continued at a faster pace in the first quarter of 2009. Inflation declined across all sub-categories, while the short-term exchange rate pass-through on prices remained weak.

After a steep increase in the final quarter of 2008, unprocessed food prices continued to rise in the first quarter of 2009. However, food prices increased at a more moderate pace compared to the previous years, owing to the marked slowdown in processed food prices. Thus, our food price assumptions are in line with the path outlined in the baseline scenario of the January 2009 Inflation Report. Accordingly, food inflation is assumed to be 7.5 and 6 percent, respectively, for end-2009 and onwards.

In the January Inflation Report, we had forecasted that the economic contraction in the first three quarters of 2008 would continue into the fourth quarter at a faster pace. Therefore, assuming that total demand conditions would provide an added support to disinflation, we had significantly revised down our fourth-quarter output gap forecasts that underlie our medium-term projections. Fourth-quarter GDP releases appear to confirm our projections. Domestic demand made less contribution to growth, while the contribution from net foreign demand to growth increased over a quarter earlier, and as we expected, total demand gave an added support to disinflation in the fourth quarter.

In the first quarter of 2009, the outlook for global growth and foreign demand was worse than expected in the previous Report. Amid mounting signs of a protracted global recession and a resulting prolonged weakening in foreign demand, we expect domestic demand to slump further in the first quarter and annual GDP growth to hit a historic low. On balance, we built our forecasts on the assumption that domestic demand will be more sluggish in the first quarter than projected in the January Inflation Report.

In sum, the support from total demand conditions to disinflation increased in the first quarter, and our first-quarter output gap forecasts, that form the starting condition of our medium term forecasts, have been revised down sharply, compared to the previous Report. This downward revision has been the key driver of the change in the outlook for inflation and monetary policy.

Policy rate cuts and fiscal stimulus packages are expected to help promote domestic demand in the remainder of the year. Yet, in the face of an extraordinary economic climate, we believe that domestic recovery largely depends on global implications. Therefore, unless problems in the global economy are solved, we do not expect a marked rebound in domestic credit markets and, thus, domestic demand. In this respect, we built our output gap forecasts on the assumption that total demand conditions will continue to support disinflation through 2009.

In the previous Report, we indicated that financial conditions continued to tighten, but expected that the monetary easing since November 2008 would provide some stimulus to the credit market. Developments in the credit market have confirmed this projection. With the recent policy rate cuts, loan rates have partially declined, leading to a slight rebound in consumer loans and reducing the pace of decline in business loans. However, the ongoing risk aversion and continued tightening in global credit conditions had a dampening effect on domestic credit expansion. Therefore, our forecasts are based on the assumption that credit conditions will continue to tighten, albeit at a slower pace than in the January Inflation Report.

After falling in the fourth quarter of 2008, oil prices remained flat in the first quarter of 2009. Brent crude oil prices stabilized between USD 40 to 50 per barrel in the first quarter (USD 44.6 on average) and averaged USD 51 per barrel in mid-April. In view of the upcoming oil price futures with several maturities, we retained our January projection for oil prices, at USD 55 per barrel.

Given the current economic climate, assumptions on foreign economic activity have become increasingly important in building medium-term forecasts. The global economy plunged into a deeper crisis in the previous quarter, causing many international institutions to slash their growth forecasts for 2009 and 2010. In its World Economic Outlook April 2009 issue, the IMF cut its 2009 forecast for world growth from 0.5 percent in January to –1.3 percent (Box 2.1). The OECD cut its US and Euro area growth for 2009 from –0.9 and –0.6 percent to –4.0 and –4.1 percent, respectively. Similarly, Consensus Economics slashed its global growth forecast for 2009 from 0.5 percent in December to –2.1 percent in April. The April survey of Consensus Economics expects the US and Euro area economy to exhibit positive year-on-year growth rates by early 2010 and by the second quarter of 2010, respectively.

Overall, in the last three months, the contraction in global economic activity is increasingly assumed to be more protracted and deeper than expected. Accordingly, our global growth forecasts are based on the assumption that the world economy will sink into a deeper recession in the first quarter of 2009, than expected in the January Inflation Report, and recover gradually and slowly by mid-2010.

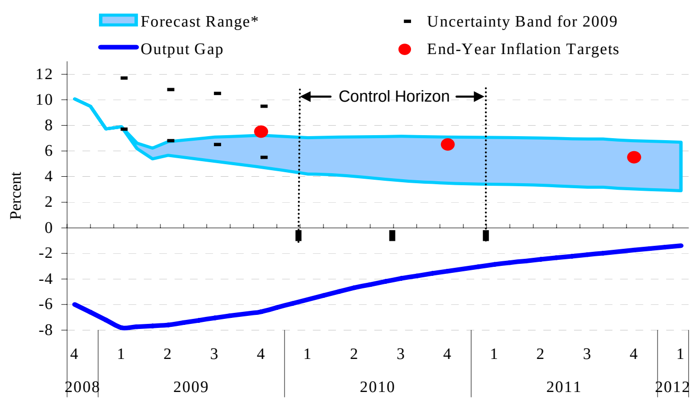
7.2. Medium-Term Outlook

This part presents our baseline scenario forecasts that are developed within the framework of the abovementioned assumptions and projections. In addition, we propose one alternative scenario, in which the global economy recovers later than expected, 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 some measured easing in the short term, and constant policy rates thereafter, with 70 percent probability, inflation will be between 4.8 and 7.2 percent with a mid-point of 6.0 percent at the end of 2009, and between 3.5 and 7.1 percent with a mid-point of 5.3 percent at the end of 2010. Furthermore, we expect inflation to come down to 4.9 percent by the end of 2011 (Graph 7.2.1.1).

Graph 7.2.1.1. Inflation and Output Gap Forecasts



*Indicates a 70-percent confidence interval for the forecast.

To sum up, weaker domestic and foreign demand, tight credit conditions, favorable cost changes and improved inflation expectations have not only led to a faster-than-envisaged rate cut cycle, but have also required a downward revision to the medium-term forecasts. The revised forecast suggests that recent rate cuts have lowered the probability of significantly undershooting the end-year inflation target (Box 1.2). However, given the tightness in financial conditions and ongoing uncertainties regarding the timing of the recovery in the global economy, it may be necessary for the monetary policy to maintain an easing bias for a considerable period.

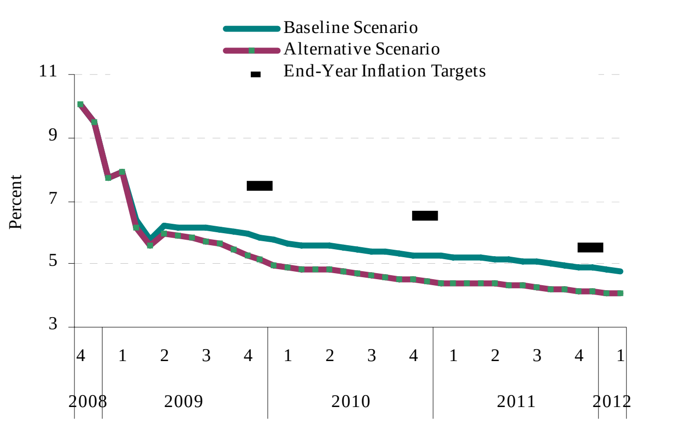
It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions on the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the Bank.

7.2.2. Alternative Scenarios and Risks

Developments in the global economy are expected to be the main determinant of the outlook for inflation and monetary policy in the medium term. Therefore, based on the above analyses, we decided to present an alternative scenario, in which the global economy starts to recover later. In this scenario, the global crisis will intensify in 2009 and the world economy will only start to recover by early 2011. Thus, commodity prices will fall below the level assumed in the baseline scenario; credit conditions will remain tight for an extended period of time; foreign demand will rebound later and slower due to the belated recovery in global economy. Accordingly, crude oil prices are assumed to drop to USD 45 per barrel by the end of 2009 and remain flat over the forecast horizon. Our new oil price assumption is higher than that in the January 2009 Inflation Report due to OPEC's announcement to block sharp drops in oil prices. Furthermore, food inflation is also assumed to be lower than in the baseline scenario, hitting 5.5 and 5 percent, respectively, by the end of 2009 and onwards.

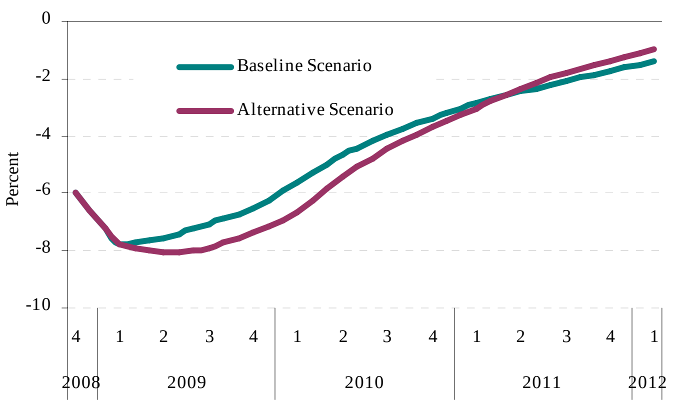
Against this background, the resulting projections indicate that, assuming a sequence of measured policy rate cuts throughout 2009, with 70 percent probability, inflation will be between 3.9 and 6.5 percent with a mid-point of 5.2 percent at the end of 2009, and between 2.7 and 6.3 percent with a mid-point of 4.5 percent at the end of 2010. Moreover, we expect inflation to come down to 4.2 percent in 2011. On balance, these forecasts suggest that, in the face of a protracted global recession, inflation is likely to undershoot medium-term targets despite ongoing measured monetary easing throughout 2009 (Graph 7.2.2.1).

Graph 7.2.2.1. Inflation Forecasts: Baseline Scenario and Alternative Scenario



Output gap forecasts built on the baseline and alternative scenarios are shown in Graph 7.2.2.2. Accordingly, in both scenarios, output gap provides support to disinflation for a long period of time, with the exception that, in the baseline scenario, output gap starts to narrow by the second quarter, while in the alternative scenario, it narrows about two quarters later.

Graph 7.2.2.2. Output Gap Forecasts: Baseline Scenario and Alternative Scenario



The stance of fiscal policy is another major factor that may affect the outlook for inflation and monetary policy. Recently, budget revenues have been declining in line with the slowdown in economic activity, while expenditures have been accelerating due to countercyclical fiscal policy, leading to a significant rise in the budget deficit. Possible adjustments in excise taxes and/or administered prices in order to stabilize the budget could result some inflation volatility over the short term. Moreover, the increasing financing requirement of the government might weaken the favorable impact of monetary policy decisions on economic activity. Therefore, in order to reap the gains from short-term expansionary fiscal policy, it is important to commit to a credible medium-term fiscal framework that would ensure fiscal discipline and debt sustainability.

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2. INTERNATIONAL ECONOMIC DEVELOPMENTS

3. INFLATION DEVELOPMENTS

4. SUPPLY AND DEMAND DEVELOPMENTS

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6. PUBLIC FINANCE

7. MEDIUM TERM PROJECTIONS

TABLES

ABBREVIATIONS

AMA	Automotive Manufacturers Association
BoE	Bank of England
BoJ	Bank of Japan
CBRT	Central Bank of the Republic of Turkey
CDS	Credit Default Swap
CPI	Consumer Prices Index
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EU	European Union
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
IMF	International Money Fund
LIBOR	London Interbank Offered Rate
MPC	Monetary Policy Committee
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PEP	Pre-Accession Economic Program
PMI	Purchasing Managers Index
RUSF	Resource Utilization Support Fund
SCA	Special CPI Aggregates
SCT	Special Consumption Taxes
TL	Turkish lira
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VAT	Value Added Taxes
WEO	World Economic Outlook