Ankara, July 28, 2008

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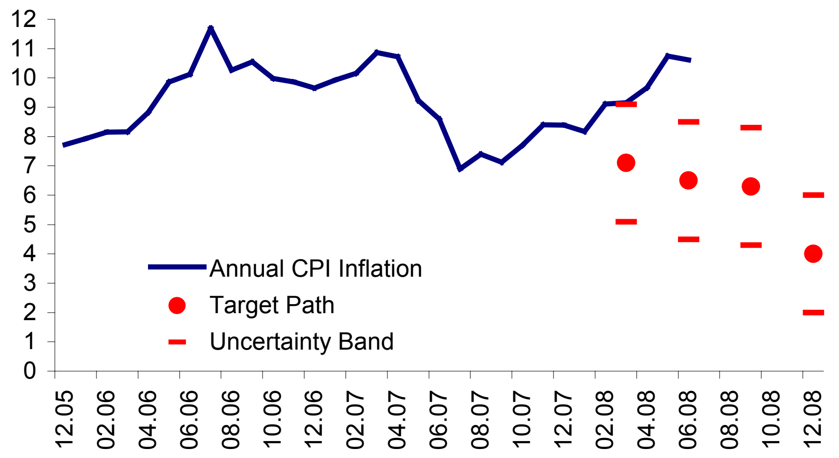
The Central Bank of Turkey (CBT) has been implementing an inflation targeting regime since the beginning of 2006. Central Bank Law, as stipulated in the Article 42, requires the CBT to be accountable for the non-fulfillment of inflation targets. Inflation target for end-year 2008 was jointly set with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

Inflation outturn as of June 2008 was 10.61 percent, breaching the upper limit of the uncertainty band, which was set at 8.5 percent for the end of the second quarter (Figure 1). Accordingly, this open letter explains the reasons for this breach and presents the strategy adopted by the CBT to bring inflation back to the medium term targets.

Figure 1: Annual CPI Inflation and Target Path

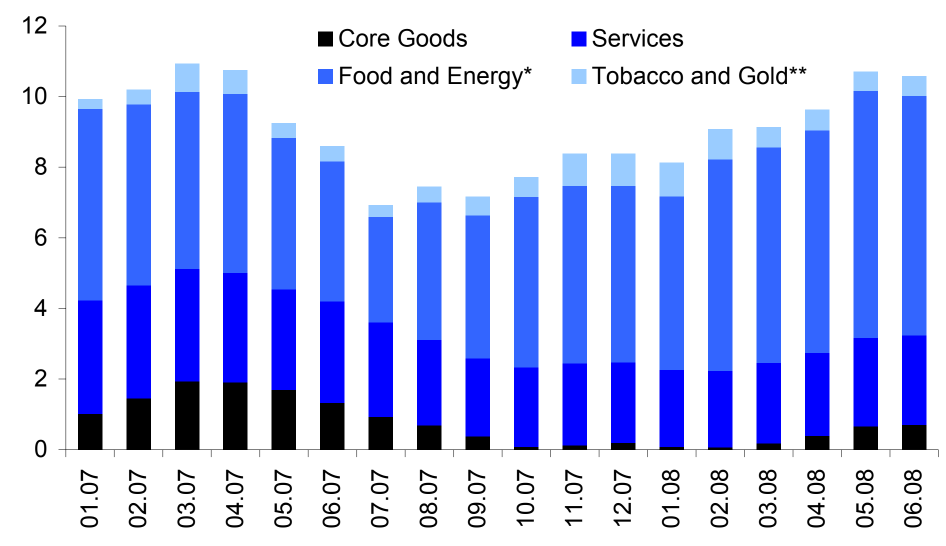


Source: TURKSTAT, CBT.

Reasons For Breaching the Target

The open letter dated April 2008 had presented a detailed explanation for breaching the target in the first quarter of the year. The source of inflation has not changed in the past quarter. Prolonged increases in food, energy and other commodity prices have continued to exert significant upward pressures on headline inflation. As a consequence 6.8 percentage points of the 10.61 percent annual CPI inflation in June resulted from the direct impact of the rise in food and energy prices (Figure 2).

Figure 2: Contribution to Annual CPI Inflation



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

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

Source: TURKSTAT, CBT.

Elevated food inflation was the main factor impeding the disinflation process. Although domestic weather conditions turned more favorable in the first half of 2008, lagged effects of last year's poor harvest and continued elevation in agricultural commodity prices continued to keep processed food inflation at high levels.[1] As a consequence, processed food inflation displayed a cumulative increase of 14.2 percent in the first half of the year.

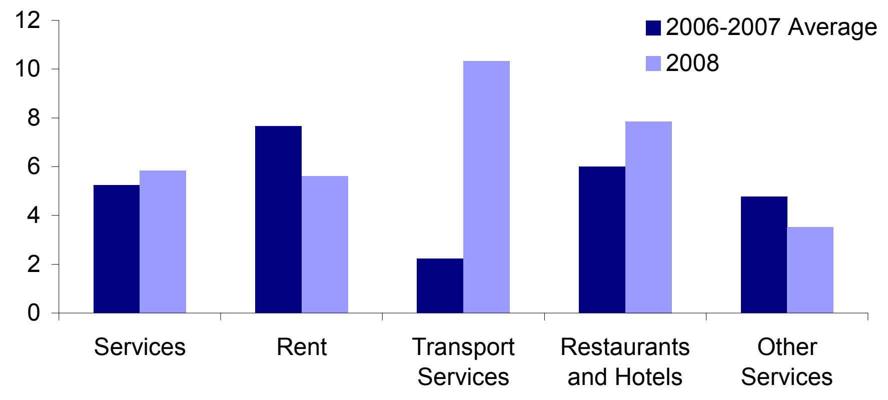
Developments in energy prices have been the other major factor driving inflation in the second quarter. Soaring oil prices continued to lead to significant hikes in the prices of domestic fuel products, also putting pressure on housing utilities such as electricity and natural gas.

Services inflation displayed a limited rise in the first half of 2008. Food and energy prices continued to exert upward pressures on the prices of catering and

[1] Chapter 3 of the July Inflation Report provides a detailed explanation on the factors driving domestic food prices.

transport services. Rents and other services, on the other hand, continued to decelerate (Figure 3).

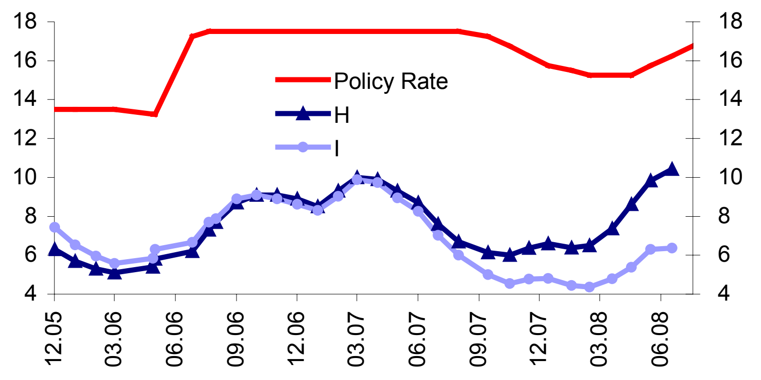
Figure 3: Subcomponents of Services Index
(First Half Cumulative Percentage Change)



Source: TURKSTAT, CBT.

The rise in core inflation in the second quarter should be viewed as a temporary movement arising from the exchange rate pass-through, rather than deterioration in the general price setting behavior. Ongoing difficulties in global credit markets coupled with domestic uncertainties have led to a depreciation of Turkish Lira *vis-à-vis* major currencies in the first four months of the year. As a consequence, first round effects of exchange rate pass-through have been significant on the headline inflation as well as on core inflation figures during the March-May period. Yet, the recent rebound in Turkish lira and weakening domestic demand has limited the overall pass-through and consequently core inflation showed signs of easing in June. Currently, annual rate of increase in CPI excluding food, energy, tobacco and gold items stands at 6.4 percent, confirming that the breach of the inflation targets can be mostly attributed to factors beyond the control of the monetary policy (Figure 4).

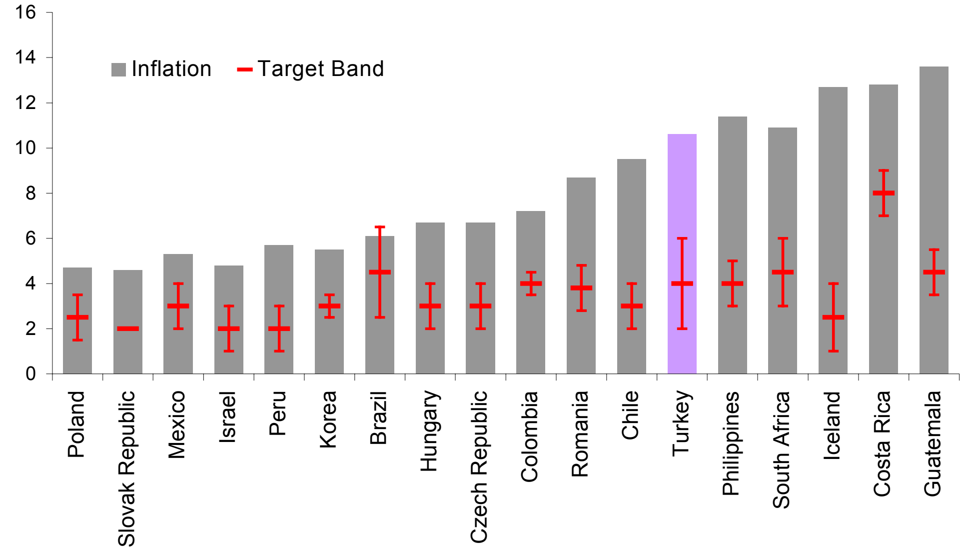
Figure 4: Main Inflation Indicators and Policy Rates



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

Elevated commodity prices have continued to exert inflationary pressures all over the world. As depicted in Figure 5, almost all emerging economies under inflation targeting have faced significant breaches in their inflation targets.

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

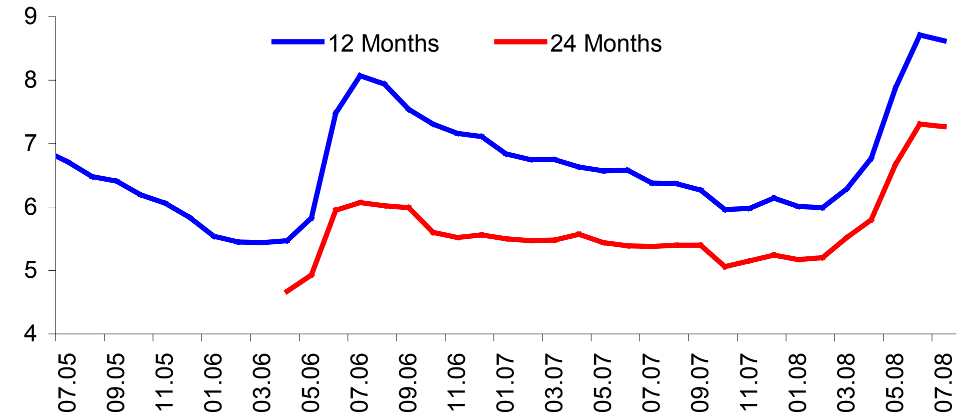


Source: Web sites of central banks, IFS, TURKSTAT, CBT

Reaction of Monetary Policy

In the open letter dated April 2008, we indicated that uncertainties in the global economy, hikes in energy prices, and the risks to price setting behavior compelled the monetary policy to be more responsive to the incoming information. The letter revealed a clear tightening bias against increased risks related to the second round effects of the supply side shocks. Food and energy prices continued to rise in the second quarter of 2008 and financial markets remained under stress. In the meantime domestic uncertainties have intensified, having further adverse impact on the medium term inflation expectations. Accordingly, there has been a significant upward surge in the medium term inflation expectations in the second quarter of 2008 (Figure 6).

Figure 6: Inflation Expectations*



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

In order to contain the deterioration in inflation expectations and to prevent the materialization of the second round effects of supply-side shocks, the MPC tightened monetary policy in the past three months, increasing the policy rates by a cumulative of 150 basis points (Table 1). The monetary tightening was effective in controlling expectations. Consequently, the deterioration in inflation expectations came to a halt in July (Figure 6).

Table 1: Monetary Policy Committee (MPC) Decisions in 2007 and 2008

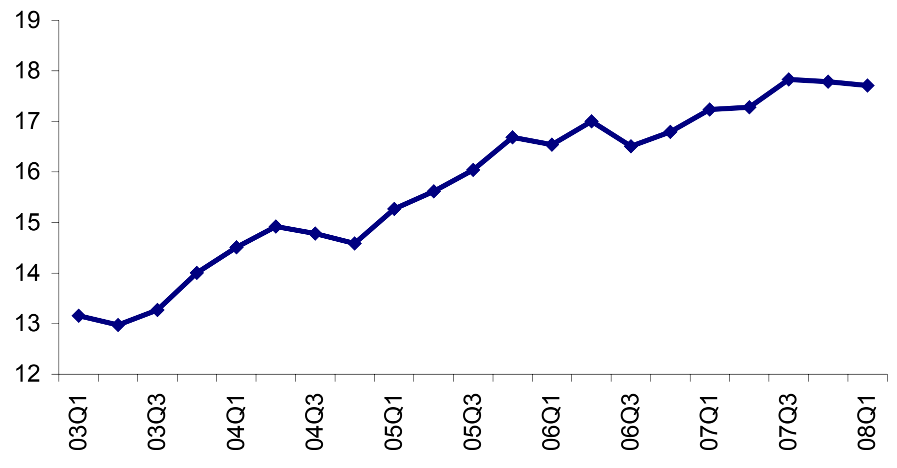
Dates for MPC Meetings	Decision on Interest Rates	Interest Rate
January 16th, 2007	No Change	17.50
February 15th, 2007	No Change	17.50
March 15th, 2007	No Change	17.50
April 18th, 2007	No Change	17.50
May 14th, 2007	No Change	17.50
June 14th, 2007	No Change	17.50
July 12th, 2007	No Change	17.50
August 14th, 2007	No Change	17.50
September 13th, 2007	-0.25	17.25
October 16th, 2007	-0.50	16.75
November 14th, 2007	-0.50	16.25
December 13th, 2007	-0.50	15.75
January 17th, 2008	-0.25	15.50
February 14th, 2008	-0.25	15.25
March 19th, 2008	No Change	15.25
April 17th, 2008	No Change	15.25
May 16th, 2008	+0.50	15.75
June 17th, 2008	+0.50	16.25
July 18th, 2008	+0.50	16.75

Source: CBT.

Inflation Outlook

Recent developments in supply and demand conditions have been in line with our assessments presented in the previous letter. Although first quarter private consumption growth at 7.3 percent appears quite strong in annual terms, the seasonally adjusted figures point to an ongoing moderation in economic activity (Figure 7). Also, recent readings on domestic sales, production and confidence indicators suggest a similar outlook.[2]

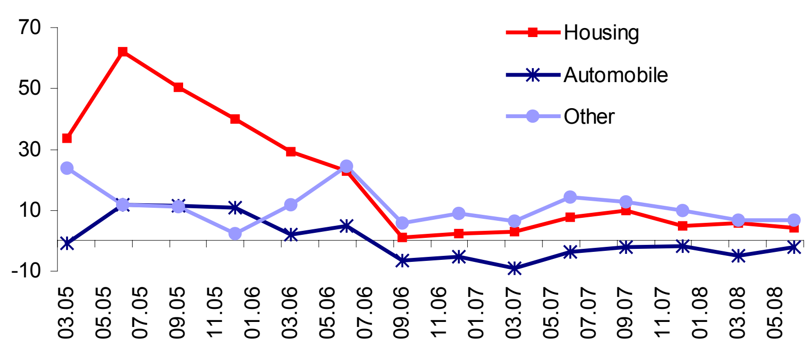
Figure 7: Private Consumption (Seasonally Adjusted, Billions, YTL)



Source: TURKSTAT, CBT.

Data on consumer credits suggest that monetary conditions continue to be restrictive. Consumer loans have been growing at a moderate pace compared to the periods of vigorous domestic demand (Figure 8). The cautious monetary policy stance, increased precautionary saving, and the tightening in global credit conditions are likely to restrain credit expansion in the period ahead.

Figure 8: Consumer Loan Growth Rate (Q-on-Q, in real terms)

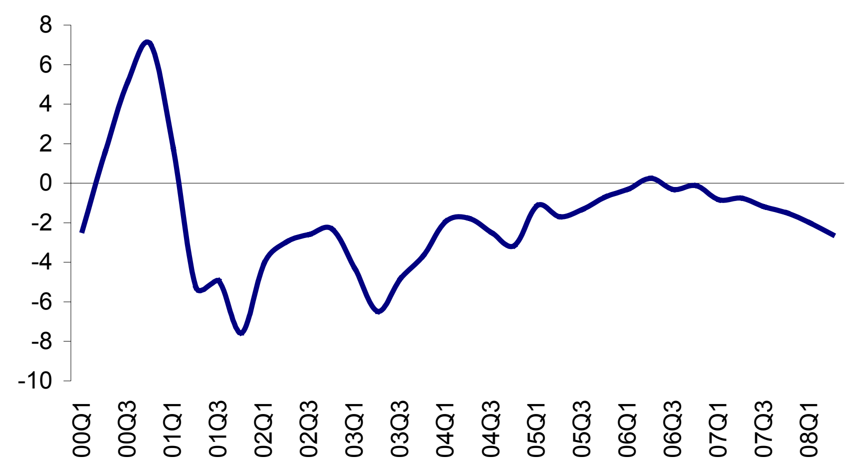


Source: TURKSTAT, CBT.

[2] See Chapter 4 of July Inflation Report for a detailed exposition of recent trends in the domestic demand.

Overall, domestic demand conditions continue to support disinflation (Figure 9). Therefore, the underlying inflation is expected to decelerate in the medium term.

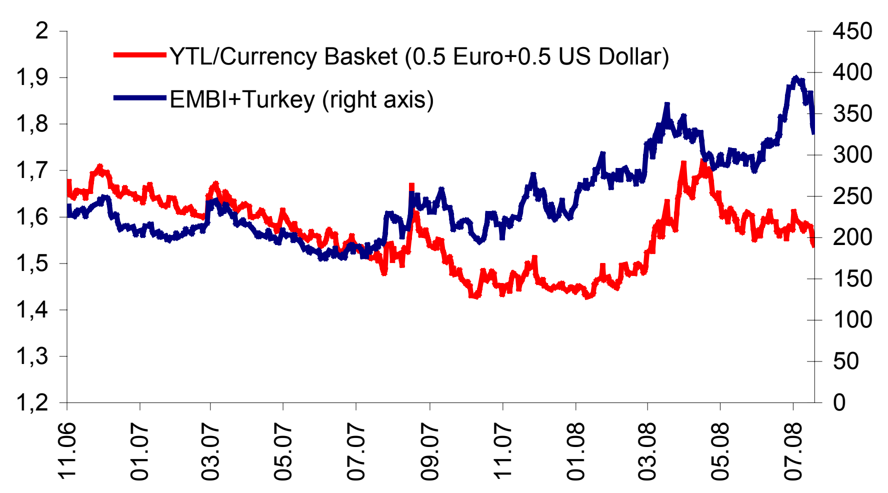
Figure 9: Output Gap



Source: CBT.

After the significant weakening of the Turkish lira in the first four months of 2008 (Figure 10), exchange rates have reversed direction in the past two months, easing to some extent potential pressures on tradable inflation resulting from the exchange rate pass-through. In the April letter, the first round impact of the recent depreciation was estimated to be close to 2-percentage points for the end-2008 headline inflation. The recent rebound in currency has led to a downward revision in the estimated pass-through. We now anticipate a cumulative exchange pass-through of around 1.2 percent points for 2008, most of which has already been materialized between March-May period.

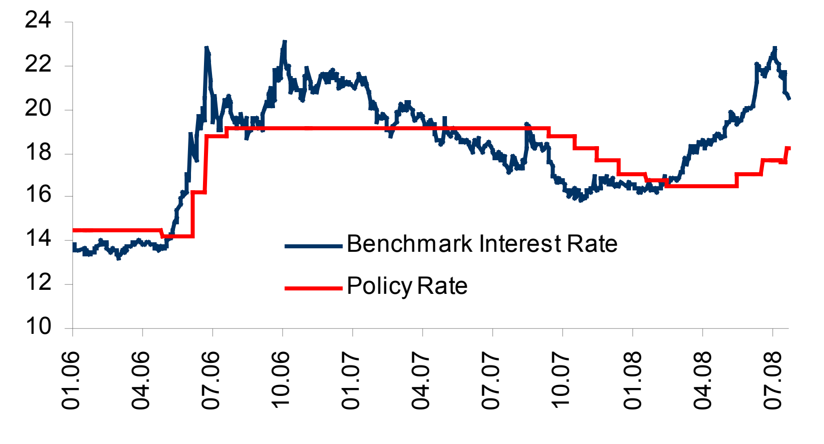
Figure 10: Risk Premium and Nominal Exchange Rates



Source: CBT.

Longer-term interest rates have also increased in the second quarter due to rising risk premium and inflation expectations (Figure 11). Although higher interest rates contain the domestic demand and support disinflation, the impact of the heightened risk premium on the overall pricing behavior should be closely monitored.

Figure 11: Benchmark Interest Rate and Policy Rate



Source: CBT, ISE.

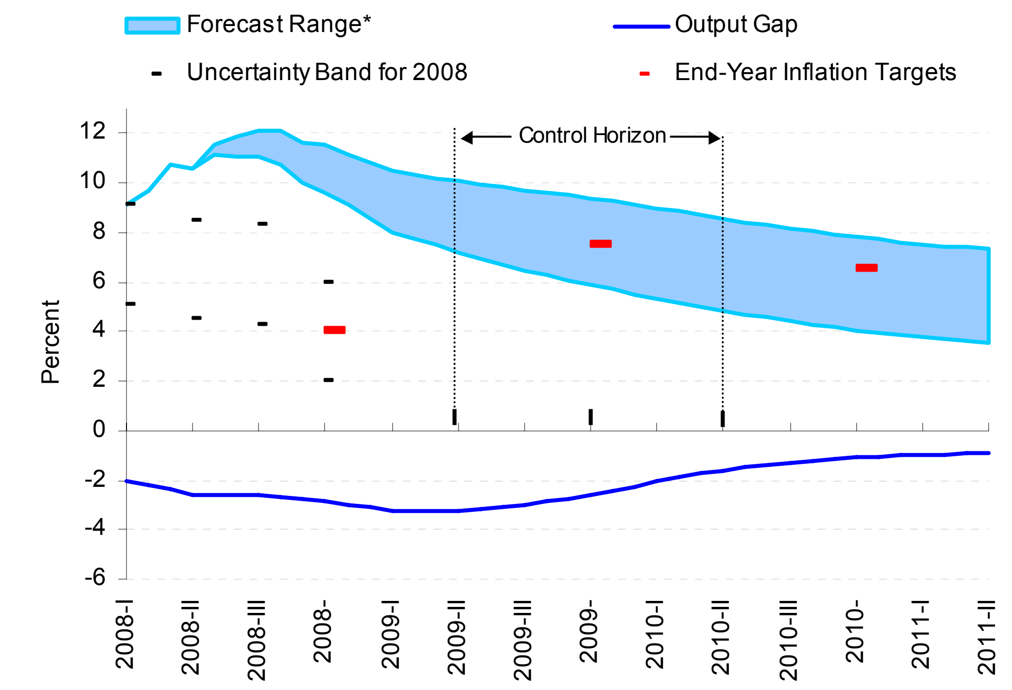
Baseline assumptions in the April Inflation Report envisaged a constant path for oil prices around 105 USD per barrel over the forecast horizon. However, oil prices continued to rise on the back of increasing international commodity prices, necessitating an upward revision. Taking the average future prices in the first three weeks of July as a benchmark, our baseline scenario for oil prices has been revised to USD 140 per barrel.[3] This revision has increased the end-2008 inflation forecast by 1.8 percentage points, and also added to the end-2009 forecasts 0.6 percentage points.

Our revised forecasts envisage slightly higher food inflation in 2008 and 2009 compared to the April Inflation Report. Although unprocessed food prices followed a relatively favorable course, processed food inflation is likely to stay at high levels for while, given the elevated course of agricultural commodity prices. Against this backdrop, we have raised the assumptions for food inflation from 13 percent to 14 percent for the year 2008, and from 8 percent to 9 percent for the year 2009. These changes have led to an upward revision in our inflation forecasts by about 30 basis points, both for 2008 and 2009. The projections envisage gradually moderating food inflation throughout the forecast horizon. In this context, assumption for 2010 food inflation is 7 percent.

[3] We also assume that the adjustment of electricity tariffs in the context of automatic pricing mechanism will be compatible with the oil price scenario.

Accordingly, we now forecast inflation to be around 10.6 percent at the end of 2008. Under the assumption of a limited tightening towards the end of 2008, our medium term forecasts suggest that, with 70 percent probability, inflation will be between 5,9 and 9.3 percent (mid-point 7,6) at the end of 2009, and between 4 percent and 7.8 per cent (mid-point 5.9) at the end of 2010 (Figure 12). Our inflation forecast for mid-2011 is 5.4 percent. We expect non-food inflation to be lower than these figures.

Figure 12: Inflation Forecasts*



Source: CBT

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

To sum up, although economic activity in the past quarter have evolved in line with our expectations, the significant increases in oil and processed food prices have led to an upward revision in our forecasts. The main message of the forecast is that preventing the materialization of potential second round effects and ensuring a steady decline in inflation towards the medium term targets, requires the monetary policy to maintain a cautious stance for a while.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in our policy stance. Therefore, the path for the policy rates indicated above should not be perceived as a commitment on behalf of the CBT.

Risks

Our baseline scenario is based on quite conservative assumptions for food and energy prices, implying that downside risks on these factors are as significant as upside risks.[4] Should the upside risks materialize, monetary policy will be conducted so as to minimize upside deviations from the targets. Downward surprises in food and energy prices, on the other hand, will be perceived as an opportunity to bring inflation back to target in a shorter period than envisaged in our baseline scenario.

Despite the expected decline in inflation in the medium term, uncertainties exist regarding the degree of inflation persistence. Long-lasting supply shocks have been keeping headline inflation at elevated levels and thus increasing the risk of rising backward looking schemes in the wage and price setting behavior. Although the widening output gap should contain the second round effects of the supply shocks, the exact pace of disinflation would still depend on the extent new inflation targets serve as a strong reference for economic agents. Having this in mind, the CBT will continue to focus on enhancing the credibility of the new inflation targets. In this context, developments in the general pricing behavior and the underlying inflation trends will be monitored closely.

International financial markets remain fragile and the credit conditions continue to tighten up. The eventual impact of the financial turmoil on the global economic activity is yet to be seen. Moreover, rising commodity prices continue to be a threat for price stability. These uncertainties have been dampening the risk appetite and thus slowing down the capital flows to emerging markets, leaving these economies susceptible to shifts in the market sentiment. Domestic uncertainties have exacerbated these effects, as manifested by the significant rise in the sovereign credit risk of Turkey in the first half of the year, compared to the average risk premium of emerging economies. The CBT will not display a sharp reaction to temporary fluctuations in the financial markets, unless there is a long lasting deterioration in expectations and/or a significant worsening in the general pricing behavior.

Finally, our medium-term projections assume that government expenditures will evolve in line with the official projections and that there will be no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanisms. Any deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

Conclusion

A protracted period of rising food and energy prices has been hampering our disinflation efforts since the adoption of the inflation targeting regime. Ongoing uncertainties resulting from global as well as domestic factors have necessitated a more cautious monetary policy stance by leading to a significant deterioration in inflation expectations. In order to prevent the materialization of the risks associated

[4] In order to address these risks, July Inflation Report presents inflation projections and the relevant policy response under alternative scenarios for food and energy prices.

with the second round effects of rising inflation expectations, we have conducted a monetary tightening over the past three months. Monetary tightening was effective in containing inflation expectations, as the deterioration in inflation expectations came to a halt in July.

Current stance of monetary policy supports disinflation. We expect inflation to remain at elevated levels in the short term before gradually moderating towards the targets. Our latest inflation forecasts suggest that inflation targets of 7.5 percent, 6.5 percent, and 5,5 percent set for the next three years in the Medium Term Program are attainable, even under quite conservative assumptions on food and energy prices. Adverse impacts of the supply side shocks on the economy will be more limited should all the economic agents take these targets as a benchmark in forming their expectations.

Prudent monetary policy is a necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical in the road to price stability. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance the productivity, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.

We have also attached, for your consideration, our latest Inflation Report dated July 28th of 2008, which provides a more comprehensive analysis of the issues presented in this open letter.

Yours Sincerely,

CENTRAL BANK OF TURKEY
Head Office

Durmuş Yılmaz	Erdem Başçı
Governor	Deputy Governor