CENTRAL BANK OF THE REPUBLIC OF TURKEY

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Keynote Address

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Dear Guests,

I am delighted to be here to address such a distinguished audience in Istanbul. I hope this timely and important Forum will contribute much to debates about future growth prospects of Turkey, through exploring many prominent issues.

Let me begin with recent developments in international markets and their impacts on the Turkish economy.

As you may all know, both developed and emerging countries have been suffering from higher inflation and lower growth rates for a while. There are two main reasons behind this undesirable economic situation. One is the turbulence that emerged in the second half of 2007 in financial markets; and the other one is the continuously increasing global commodity prices.

The second half of 2007 was not an easy period for central bankers – and 2008 is likely to be even more challenging. There is an apparent acceleration in consumer prices inflation all over the world and the annual inflation even in developed countries is at its highest level of the last 16 years. Improvement in the wealth of big developing countries such as China and India has created a demand-driven pressure on commodity prices. Moreover, the utilization of foodstuff in the bio-fuels production combined with the unfavorable weather conditions last year has led to further increases in commodity prices. Despite economic slowdown expectations in developed countries, the surge in commodity prices has continued in 2008 and the oil prices reached USD 140 per barrel.

On the other hand, the sub-prime mortgage crisis that has started in the U.S. in mid 2007 has grown to a level that threatens the stability of financial system in many countries. The growth expectations were scaled back significantly.

The turbulence might also have negative implications on the Turkish economy. Nevertheless, economic indicators show that the Turkish economy's resistant to fluctuations in global markets has increased substantially, compared to the previous episodes of turbulences. The current relative resilience is an outcome of the successfully and decisively implemented macroeconomic policies since 2001 together with comprehensive structural reforms.

Still, we are facing challenges now. The year-on-year consumer price inflation climbed to double-digit levels in May and it will probably remain high till the last quarter of this year and then decline gradually. Moreover, the growth rate of the GDP stood at 4.5% in 2007, as compared to 2001-2006 period, which was 7.2% on the average.

Dear Guests,

Turkey has several comparative advantages compared to many of its counterparts that can support high growth rates in the medium term.

The first one is the demographic structure. Turkey has a young and skilled population that is one of the most important ingredients of economic growth. More than half of Turkey's population is under the age of 30. However, unemployment rate for the young population stands at 21.2%. In order to unleash our potential, we need to keep investments at high levels and utilize human capital effectively. Since domestic savings rate in Turkey is not high enough to finance investments, we need to attract foreign savings, which implies having current account deficit. But the good news is that the quality of financing has improved significantly in recent years. The FDI inflows were more than USD 20 billion in each of the last two years. Nevertheless, I should say that ratio of greenfield FDI to the total FDI is relatively low yet. I believe that the greenfield FDI will also increase in the following years as we keep the macroeconomic and political stability in place and continue to improve the business environment.

The second comparative advantage that I would like to underline is the convergence story of Turkey to European Union. Steps taken during the negotiation process will undoubtedly increase the momentum of Turkey and help unlock the growth potential of the country. European Union membership is our medium-term anchor and all parties in Turkey should adhere to this aim decisively.

Dear Guests,

The best way that a central bank could support sustainable growth is reaching and maintaining price stability, especially in a country that experienced high and chronic inflation for decades.

As you may know, Turkey has adopted the full-fledged inflation-targeting regime in 2006. Looking back, one can notice that a protracted period of rising food and energy prices have led to a significant over shooting of the inflation targets since the adoption of the inflation targeting regime. This has increased the stickiness in inflation expectations, as economic agents have become more backward looking. Under normal conditions, supply shocks are expected to alter relative prices rather than the underlying inflation trend. Nevertheless, the fact that several long lasting shocks appeared concurrently has increased the risks to the price setting behavior. Our revised projections incorporating the latest developments suggest that it will take a relatively long time for inflation to reach 4 percent level. Even more importantly, current inflation target no longer seems to serve as a nominal anchor in the short term.

Inflation targeting regime is one of the monetary policy regimes and all regimes have their own rules and frameworks. Our main policy document published in December 2005 describes the framework of our inflation-targeting regime. 24th paragraph of that document states that:

"A pre-announced inflation target shall only be changed in the event that very sharp and long-term deviations from the target are expected or medium-term targets no longer make sense due to factors beyond the control of monetary policy. At this point, a new target will be set with the government with respect to the Law."

The paragraph that I have just read completely defines the recent conditions and explains why we revised the inflation targets for 2009 and 2010. Under these conditions, a revision in inflation targets has become a technical necessity. Therefore, the Central Bank of Turkey proposed the government to revise the targets for 2009 and 2010 to 7.5 and 6.5 percent, respectively; and to set the target for 2011 at 5.5 percent, and the government accepted our proposal.

I would like to re-emphasize that, we will not treat the revised targets symmetrically. Monetary policy will aim to keep inflation below the revised target path.

Dear Guests,

We stick to our price stability objective. At the same time, we are aware of challenges we have to face.

First of all, the rapid rise in food prices may be more permanent than expected due to rapid economic growth, slowdown in agricultural productivity and employment shift from agriculture to industries. Considering the fact that food has a higher share in the consumption basket of developing economies, including Turkey, this would lead to a decoupling in inflation rates between industrialized world and developing countries for years to come.

Similarly, commodity prices may remain elevated for the foreseeable future, which may prove to be a challenge for Turkey in particular. Note that Turkey is a net commodity importer in contrast to many other developing countries.

Last, but not least, price stability necessitates stability in financial markets. We need to put our house in order to attract foreign capital with long-term horizon, rather than highly mobile short-term capital. I believe structural reforms together with macroeconomic stability, fiscal discipline and prudent monetary policies will create the necessary economic environment to achieve and maintain sustainable growth rates and price stability in the future.

Thank you.