Ankara, April 30, 2008

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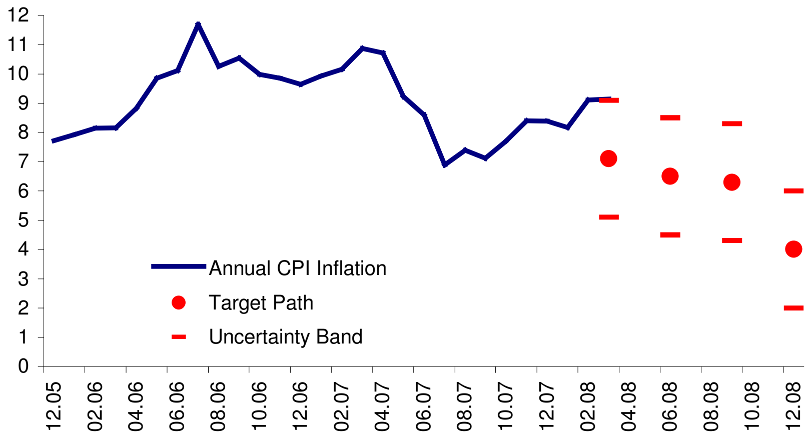
The Central Bank of Turkey (CBT) has been implementing a formal inflation-targeting regime since the beginning of 2006. Central Bank Law, as stipulated in the Article 42, requires the CBT to be accountable for the non-fulfillment of inflation targets. Inflation target for end-year 2008 was jointly set 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 March 2008 was 9.15 percent, breaching the upper limit of the uncertainty band, which was set at 9.1 percent for the end of the first quarter (Figure 1). Accordingly, this open letter explains the reasons for this breach, presents the measures we have taken, and puts forth our monetary policy strategy for the forthcoming period. This Open Letter will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual CPI Inflation and Target Path



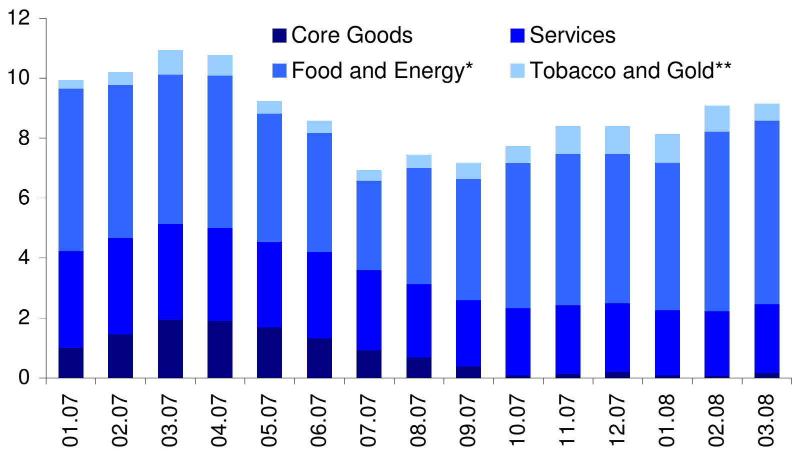
Source: TURKSTAT, CBT.

Reasons For Breaching the Target

The monetary tightening exercised since mid-2006 has been successful in leading to a significant reduction in underlying inflation. The fall in headline inflation, however, was more limited, owing mainly to factors largely beyond the control of monetary policy, such as developments in food, energy, and administered prices.

Prolonged increases in food and energy prices have recently led to upward pressure on headline inflation and in turn to upward revisions in inflation forecasts in many countries across the world. Turkey is not an exception in this regard, as deviations of inflation from our forecasts can be mostly attributed to these factors. For instance, our forecasts in October 2006 Inflation Report suggested that inflation would converge to the 4 percent target at the end of the first quarter of 2008. The forecast was based on a scenario where food inflation moderated to levels comparable with medium term targets and oil prices remained stable at 60 USD per barrel. However, oil prices continued to rise and averaged around 100 USD per barrel in the first quarter of 2008. Moreover, annual food price inflation has continued to remain at elevated levels, reaching 13.4 percent in March. As a consequence 6.13 percentage points of the 9.15 percent annual CPI inflation in March resulted from the food and energy items (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.

Both domestic and international developments have played a part on the course of food prices. A prolonged shortage of rainfall in Turkey resulted in low crop yields in 2007, which in turn translated to an adverse supply shock. Strong global demand for food and continued elevation in agricultural commodity prices further added to the domestic food inflation through the external trade channel. Recently, adverse impacts of these factors have been quite visible especially in processed food prices. Accordingly, annual food inflation maintained its high levels with a marked contribution of about 2.3 points to the 3.1 percent year-to-date headline inflation. Therefore, food prices became the main factor impeding the disinflation process (Figure 3, Table 1).

Adverse developments in energy prices have been another major factor in slowing the disinflation process. Rising oil prices continued to lead to significant hikes in the prices of fuel-oil products. Elevated oil prices also affected the prices of energy items in the housing utilities, including electricity tariff rates, which were adjusted upwards by a significant margin. Consequently, contribution of energy items to year-to-date CPI inflation reached to about 0.9 percentage points.

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Figure 3: Subcomponents of CPI (First Quarter Percentage Change)

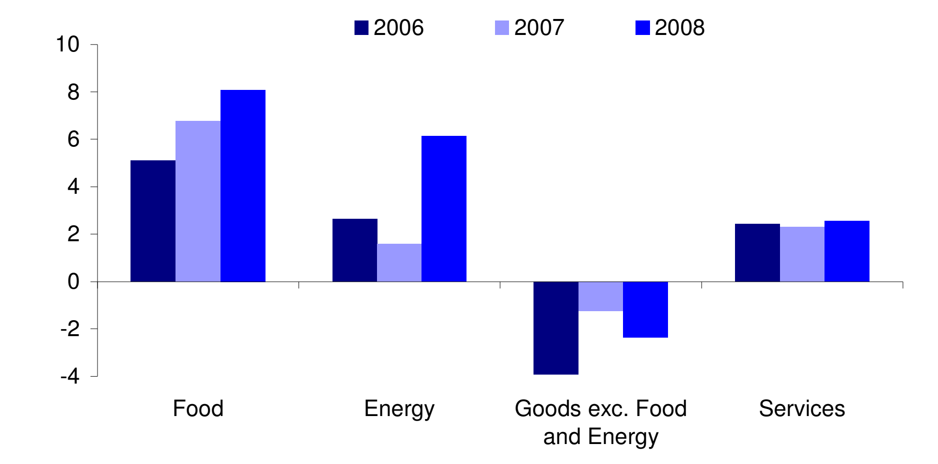


Table 1: Contribution to First Quarter CPI Inflation (Percentage Points)

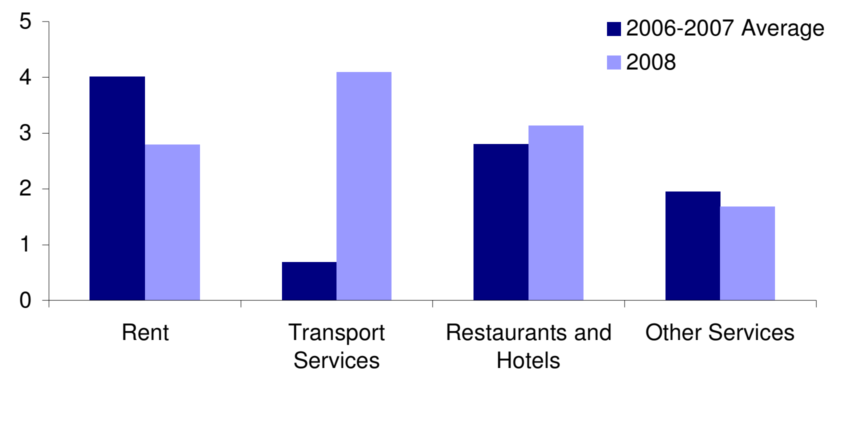
	CPI	Food*	Energy	Goods exc. Food and Energy	Services
2008	3,09	2,31	0,86	-0,74	0,65
2007	2,36	1,93	0,22	-0,39	0,60
2006	1,25	1,41	0,38	-1,20	0,66

*Food: Food and non-alcoholic beverages.

Source: TURKSTAT, CBT.

The decline in services inflation came to a halt in the first quarter of 2008. Elevated food and energy prices have been exerting upward pressures on the prices of catering and transport services. Rents and other services, on the other hand, continued to decelerate.

Figure 4: Subcomponents of Services Index
(First Quarter Cumulative Percentage Change)

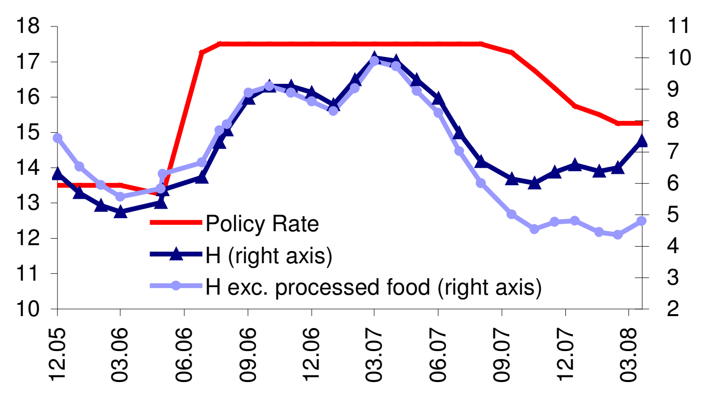


Source: TURKSTAT, CBT.

Global uncertainties and their reflections on the domestic financial markets have led to exchange rate movements, which in turn affected March inflation especially through the prices of fuel and high-tech consumer durables. First round effects of exchange rate pass-through are expected to continue in the short term.

Inflation in CPI excluding food, energy and tobacco items remained flat over the previous quarter and remained at 4.8 percent, confirming that the rise in inflation can be mostly attributed to factors beyond the control of the monetary policy.

Figure 5: Main Inflation Indicators and Policy Rates

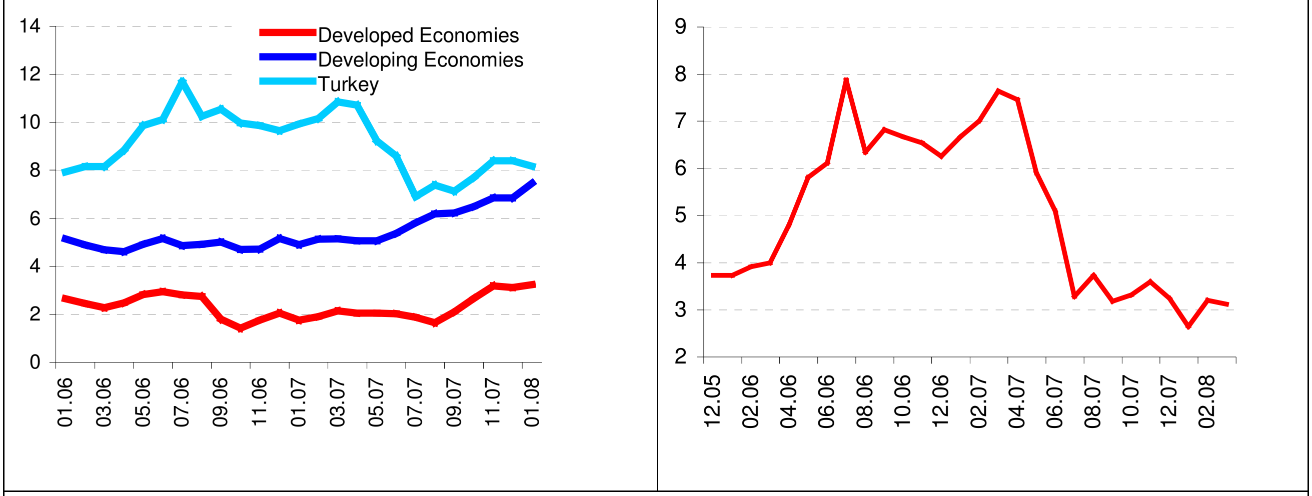


H: CPI excluding unprocessed food, energy, alcoholic beverages, tobacco, and gold.
Source: TURKSTAT, CBT.

As noted above, inflation has recently been rising all over the world (Figure 6). Elevated prices of crude oil, agricultural products and other commodities have continued to exert inflationary pressures. Inflation in developed economies edged up in the last quarter of 2007 while emerging economies under inflation targeting have been facing an upward trend since June 2007. Annual inflation in Turkey by the end of the first quarter was 9.2 percent, which is below its end-2006 level of 9.7 percent. During the same period, average inflation in emerging market economies under inflation targeting rose from 3.4 percent to 6 percent.

Figure 6: Inflation in Other Countries

a. Inflation Rates | **b.** Diff. Between Turkey and Other Emerg. IT'ers*



*Sample of emerging economies under inflation targeting covers Brazil, Czech Republic, Colombia, Philippines, South Africa, Israel, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand.
Source: Web sites of central banks, IFS, TURKSTAT, CBT

Reaction of Monetary Policy

The CBT has been clear about its approach in responding to inflation resulting from factors beyond its control: Monetary policy will tolerate the first round effects, but will promptly respond to any deterioration in the overall pricing behavior. The policy pursued since September 2007 should be interpreted in this context.

In September 2007, Monetary Policy Committee (MPC) decided to initiate the rate cuts, which had already been signaled earlier in the year. Accordingly, policy rates were lowered by 225 basis points between September 2007 and February 2008 (Table 2).

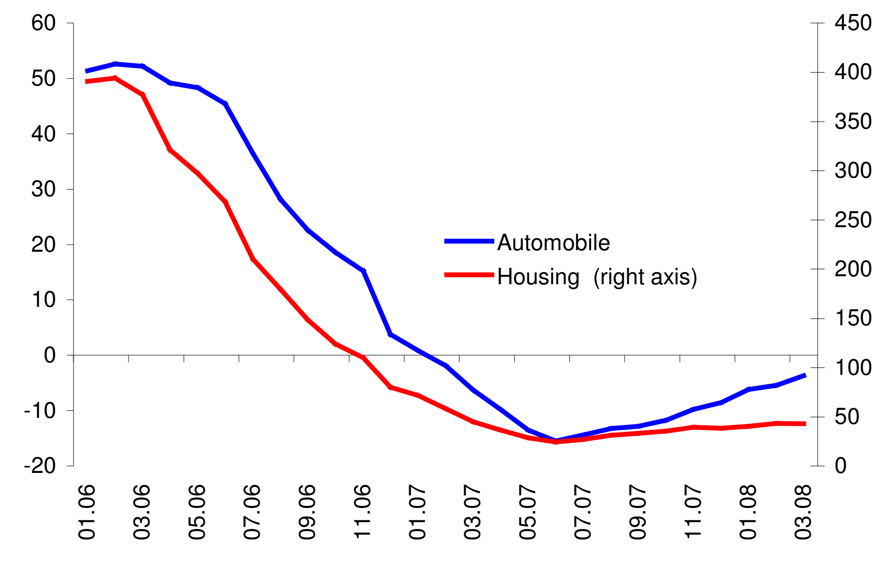
Table 2: Monetary Policy Committee (MPC) Decisions in 2007 and 2008		
Dates for MPC Meetings	**Decision on Interest Rates**	**Interest Rate**
January 16th, 2007	No Change	17.50
February 15th, 2007	No Change	17.50
March 15th, 2007	No Change	17.50
April 18th, 2007	No Change	17.50
May 14th, 2007	No Change	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
Source: CBT.		

In the January 2008 Open Letter, we indicated that uncertainties in the global economy, hikes in electricity prices, and the risks to price setting behavior compelled the CBT to be more responsive to the incoming information. The letter also expressed that further monetary accommodation would depend on the factors affecting medium term inflation outlook. Food and energy prices and global uncertainties have continued to rise since then, feeding into the inflation expectations and core prices and thus increasing the risks regarding the price setting behavior and the degree of inflation persistence. Consequently, the MPC decided to suspend the rate cuts in the March meeting and announced a clear tightening bias going forward in the April meeting.

Inflation Outlook

Current supply and demand conditions support the downward trend in inflation. Data on consumer credits suggest that monetary conditions continue to be non-accommodative. Annual growth rates in the automobile and housing loans are at lower levels compared to the periods of vigorous domestic demand (Figure 7). Although consumer credits displayed signs of recovery in 2007, the cautious monetary policy stance and the tightening in global credit conditions are likely to restrain credit expansion in the forthcoming period.

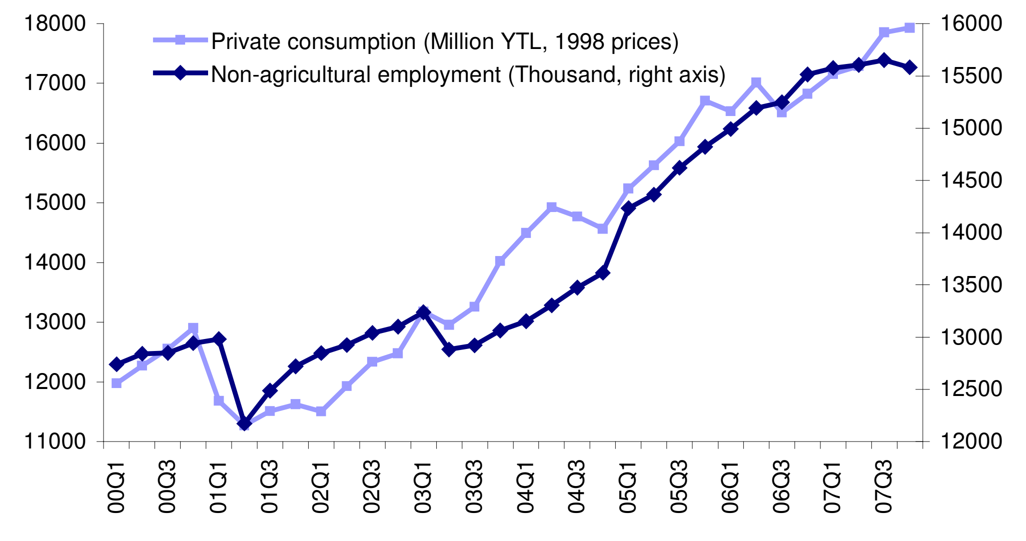
Figure 7: Consumer Loans (Annual Percentage Change)



Source: CBT.

The sharp slowdown in the second half of 2006 created a slack in the economy. The recent methodological change in national accounts led to a limited upward revision in our output gap measure and hence did not change the inflation outlook. Looking ahead, we expect a continued moderation in economic activity and non-farm employment on the back of rising precautionary saving due to global and domestic uncertainties (Figure 8).

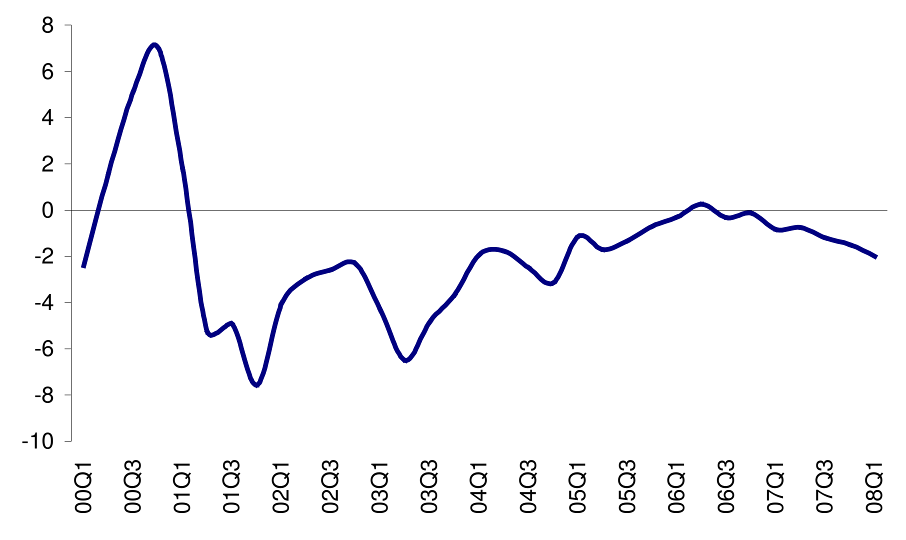
Figure 8: Private Consumption Expenditure and Non-Agricultural Employment*



*Seasonally adjusted
Source: TURKSTAT, CBT.

Accordingly, demand and capacity conditions are expected to continue to support the disinflation (Figure 9). Therefore, assuming that supply shocks gradually fade out over time, headline inflation is expected to decelerate.

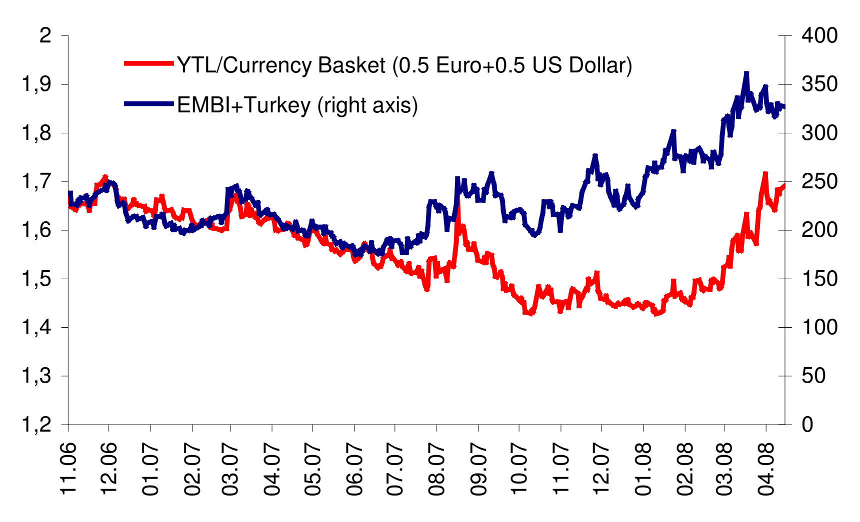
Figure 9: Output Gap



Source: CBT.

The domestic currency has depreciated by more than 15 percent in nominal terms since the beginning of the year (Figure 10). Notwithstanding the expected deceleration in the core inflation indicators in the medium term, the first round impacts of the exchange rate pass-through may be significant in the short term.

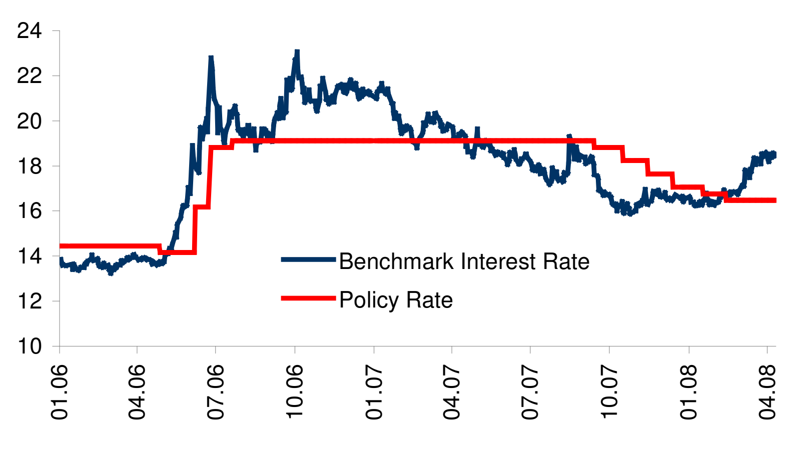
Figure 10: Risk Premium and Nominal Exchange Rates



Source: CBT.

Longer term interest rates have increased lately due to rising risk premium (Figure 11). Although higher interest rates contain the domestic demand and thus support disinflation, the impact of the higher risk premium on the pricing behavior should be closely monitored.

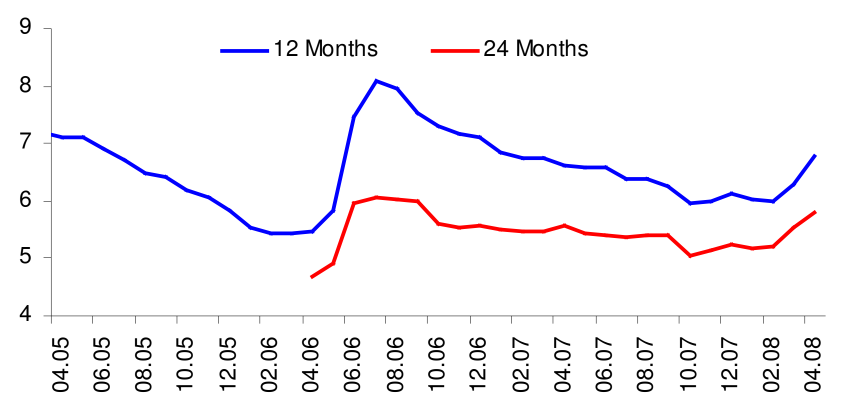
Figure 11: Benchmark Interest Rate and Policy Rate



Source: CBT, ISE.

The CBT survey of expectations suggests that economic agents expect inflation to pursue a downward trend. One year forward expectations are at 7 percent, whereas 2-year ahead inflation expectations stand at around 6 percent. However, the recent upward movement in expectations has increased the risks to the price setting behavior (Figure 12).

Figure 12: Inflation Expectations*



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

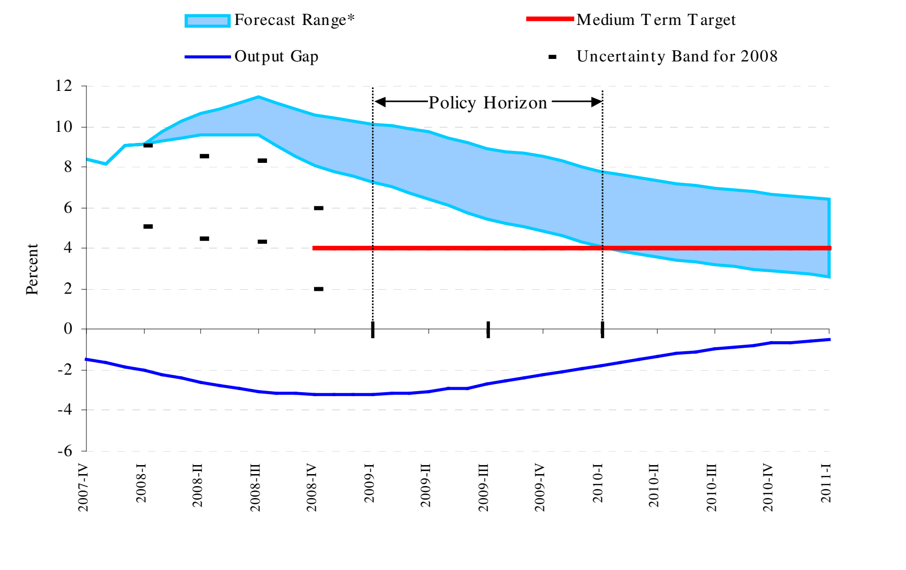
Our revised forecasts for medium term inflation incorporate more conservative assumptions on food prices compared to January Inflation Report, which envisaged a correction in food inflation justified by more favorable weather conditions. However, the long-awaited correction in food prices has not materialized yet. Processed food inflation accelerated even further on the back of rising global demand and elevated agricultural commodity prices. Against this backdrop, we have raised our assumptions for food inflation to 13 percent for the year 2008 and 8 percent for the year 2009. These changes have led to upward revisions in our inflation forecasts, by about 1.2 points for 2008 and 1.1 points for 2009.

The assumption on oil prices in the January Inflation Report stood at 85 USD per barrel. However, oil prices averaged about 100 USD in the first quarter of 2008. Considering the most recent developments, we have revised our assumption for oil prices to 105 USD per barrel. Moreover, we assume that electricity tariffs will be adjusted as needed by the automatic pricing mechanism. These changes imply upward revisions in our forecasts by 0.9 points for end-2008, and 0.4 points for end-2009.

Although weak domestic demand should limit the second round effects of the exchange rate pass-through, the first round impact of the recent depreciation is estimated to be close to 2-percentage points at the end of 2008, which implies further upward revision in our forecasts.

Accordingly, we now forecast inflation to be around 9.3 percent at the end of 2008. Our medium term forecasts suggest, with 70 percent probability that, under the assumption of a measured and gradual tightening towards mid-2008 and constant policy rates thereafter for the rest of 2008, inflation will be between 4.9 and 8.5 percent (mid point 6.7) at the end of 2009 (Figure7). Assuming a gradual moderation in food inflation, headline inflation is expected to decelerate to 4.9 percent at the end of 2010 and to 4 percent by mid-2011. We expect non-food inflation to be lower than these figures.

Figure 13: Inflation Forecasts*



Source : CBT

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

To sum up, supply shocks have turned out to be more persistent than expected, increasing the risks to the second round effects and necessitating a significant upward revision in our inflation forecasts. Accordingly, monetary policy has already assumed a more cautious stance in order to eliminate the materialization of potential second round effects. Ensuring a steady decline in inflation will likely require tight monetary policy to be maintained for an extended period. Even then, the earliest time for reaching the 4 percent medium term targets is likely to extend beyond two years.

It should be emphasized that any new data or information on 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.

Revised projections suggest that the contribution of energy, food and services will be close to 5 percent at the end of 2009. In other words, assuming no further hikes in administered prices (except the ones implied by automatic pricing mechanisms), meeting the 4 percent target at the end of 2009 would be possible only if the prices of goods excluding food, energy and tobacco deflate by 3 percent. However, factors such as rising import prices, potential second round impacts of the supply shocks, and the structural inertia in inflation could continue to impose downward stickiness in goods prices. Therefore, converging to the medium term target of 4 percent may extend beyond two years, even when tight monetary policy is maintained for an extended period.

Under these circumstances, getting inflation back to the 4 percent by the end of 2009 would require offsetting the first round effects, and thus create undesired fluctuations in the economic activity and relative prices. That is why we envisage a framework in which inflation remains higher than 4 percent at the end of 2009.

The forecasts presented above deserve particular attention, given that inflation is likely to stay above the target in the next two years. The forecasts should serve as anchors for the intermediate term, representing the inflation path that is likely to be followed on the way to 4 percent medium term target.

Risks

Our revised forecasts are based on quite conservative assumptions, especially on food and energy prices, implying that downside risks are as significant as upside risks. April Inflation Report provides projections under alternative scenarios for food and energy prices. The pessimistic scenario assumes food inflation to materialize at 17, 11 and 10 percent in the next three years, and oil prices to soar to 150 USD per barrel at the end of 2009. Under this scenario, assuming that policy rates increase gradually throughout the year 2008 and then stay constant for while, it takes four years for inflation to go back to 4 percent. The other scenario, which is the optimistic one, assumes that food inflation materializes at 9, 5 and 4 percent in the next three years, and oil prices eases to 85 USD per barrel at the end of 2009. Under this scenario, assuming a limited rate hike in the short term and gradual cuts starting from the last quarter, inflation reaches 4 percent at the end of 2010.[1] Therefore, materialization of upside risks would require further tightening of the monetary policy stance, while downward surprises in food and energy prices would be perceived as an opportunity to bring inflation back to target in a shorter period.

[1] More details on these projections are provided in the April Inflation Report.

A protracted period of rising food and energy prices have led to significant breaches in inflation targets since the adoption of the inflation targeting regime and consequently 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. Recent pick up in inflation expectations requires the monetary policy to be cautious. In this respect, recent developments in the pricing behavior and the underlying inflation trends are of particular concern. It may be necessary to pursue a tighter monetary policy should the price setting behavior further deteriorate.

Another major risk to the inflation outlook is a sharper than expected slowdown in the global economic activity, which, in turn, could lead to further volatility in financial markets. The eventual impact of the financial turmoil on the global economic activity is yet to be seen. These uncertainties have been dampening the risk appetite and thus slowing the capital flows to emerging economies. The CBT will not react to temporary fluctuations in financial markets. Yet, we will not hesitate to tighten monetary policy in case of a significant worsening in the overall 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 mechanism. Any deviation from this may have an effect on the outlook for inflation and monetary policy.

Conclusion

Inflation targets have been breached by a significant margin in the past two years as a result of exceptionally persistent supply shocks, and there is a considerable chance that the shocks are likely to stay for a while. Besides, the ongoing uncertainty resulting from the global economy has been increasing the risks related to the second round effects of these supply shocks. Our revised projections incorporating the latest developments suggest that in 2008 and 2009 inflation is likely to materialize at higher levels than 4 percent. Therefore, we envisage a framework in which inflation forecasts serve as an anchor in the short term, while 4 percent targets continue to be the medium term anchor.

Extending the horizon within which inflation converges to the target does not mean that monetary policy will be looser in the forthcoming period. On the contrary, our forecasts presented above are based on a tighter monetary policy stance compared to the previous period. Monetary policy will be more responsive to bad news than good news in the period ahead. This approach reflects our firm commitment to attaining price stability.

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.

Yours Sincerely,

CENTRAL BANK OF TURKEY
Head Office

Durmuş Yılmaz	Erdem Başçı
Governor	Deputy Governor