Ankara, October 31, 2008

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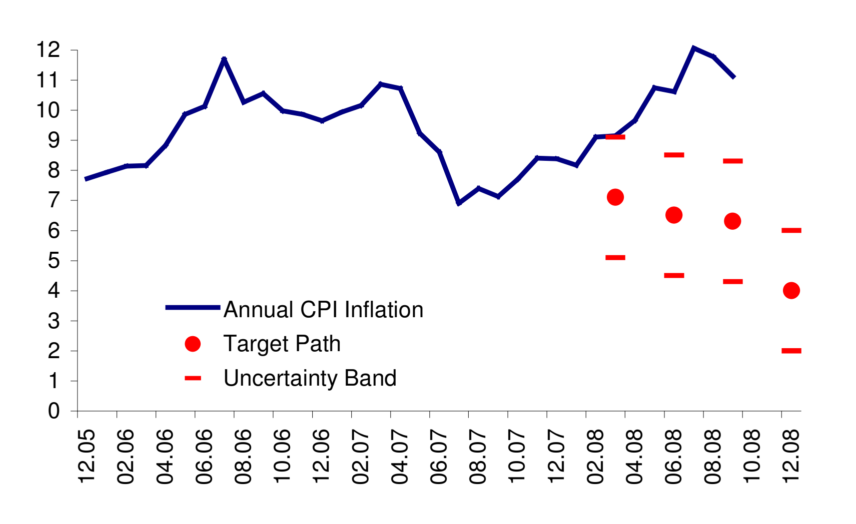
The Central Bank of Turkey (CBT) has been implementing an inflation targeting regime since the beginning of 2006. Central Bank Law, as stipulated in the Article 42, requires the CBT to be accountable for the non-fulfillment of inflation targets. Inflation target for end-year 2008 was jointly set with 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 September 2008 was 11.13 percent, breaching the upper limit of the uncertainty band, which was set at 8.3 percent for the end of the third 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



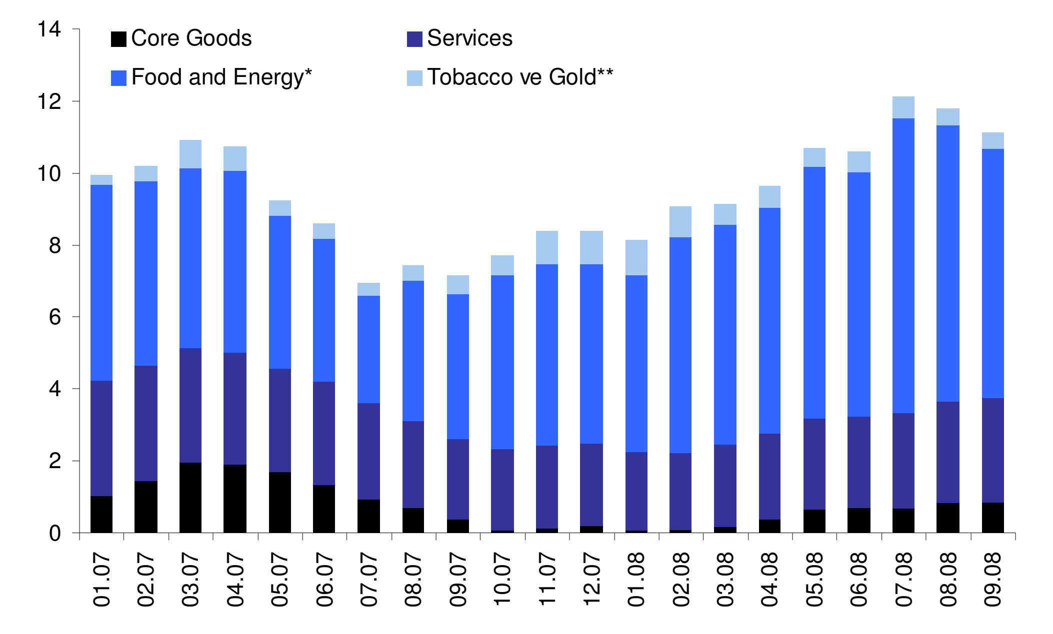
Source: TURKSTAT, CBT.

Reasons For Breaching the Target

Previous open letters dated April and July 2008 had already presented the reasons why 2008 end-year target would be breached. This section provides a brief update on inflation developments.

Main factors driving inflation in the third quarter continued to be food and energy prices. Although food, energy and other commodity prices have started to ease in September, their past increases have continued to keep annual headline inflation at relatively high levels. As of third quarter, around 7 percentage points of the 11.1 percent annual CPI inflation 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.

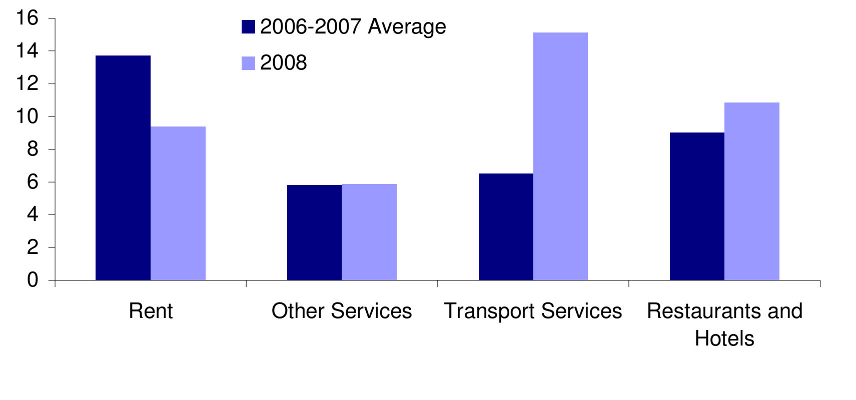
Source: TURKSTAT, CBT.

Rising energy prices was the main factor impeding the disinflation process in the third quarter. Despite the sharp downward correction in oil prices, lagged impact of the past increases continued to put pressure on other energy items such as electricity, natural gas and coal. As a consequence, the contribution of energy prices to annual inflation has reached 3.8 percent by the end of the third quarter.

Food inflation showed significant moderation in the third quarter. Favorable domestic weather conditions and easing commodity prices have helped food inflation to come down from 14 percent at the end of second quarter to 11.1 percent in the third quarter. Particularly, unprocessed food inflation, which displayed a marked correction in the past two quarters, followed a more favorable course than expected.

During the third quarter, lagged impacts of food and energy prices continued to drive up services inflation, especially through prices of catering and transport services. Rents, on the other hand, have been on a steady decline since the second quarter of 2007 (Figure 3).

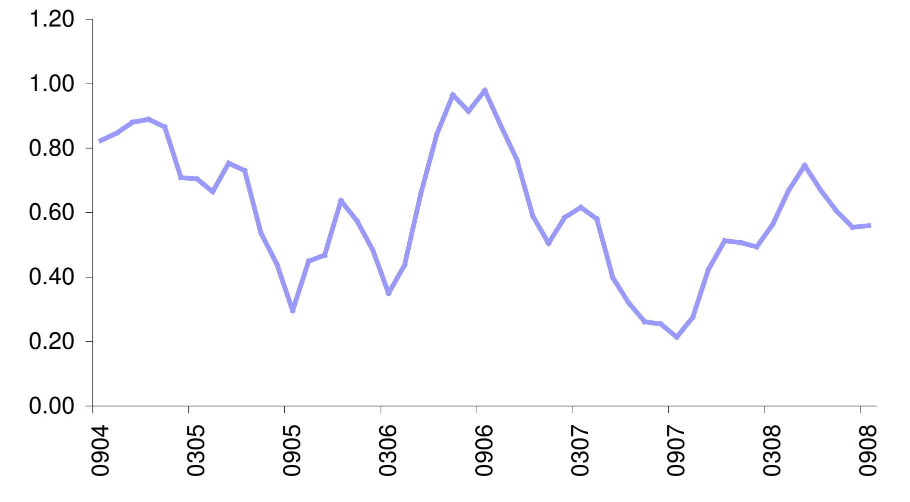
Figure 3: Subcomponents of Services Index
(First 9 Months Cumulative Percentage Change)



Source: TURKSTAT, CBT.

Annual rate of increase in CPI excluding food, energy, tobacco and gold (I) items rose to 7.3 percent from 6.4 of the previous quarter. This can mostly be attributed to last year's low base, rather than deterioration in the general price setting behavior. In fact, seasonally adjusted figures suggest that core inflation has moderated in the third quarter (Figure 4). Yet, we expect core inflation indicators to pick up in the last quarter due to recent depreciation in the Turkish lira.

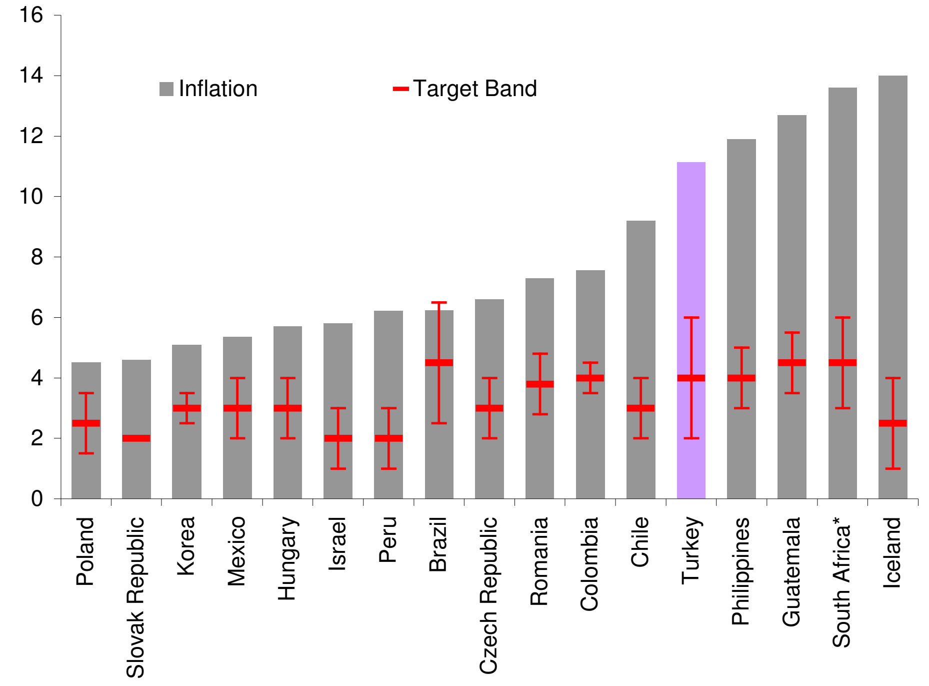
Figure 4: SCA-I*
(Seasonally Adjusted, Monthly Change, 3 Month Average)



* CPI excluding food, energy, alcoholic beverages, tobacco and gold.
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 September 2008)



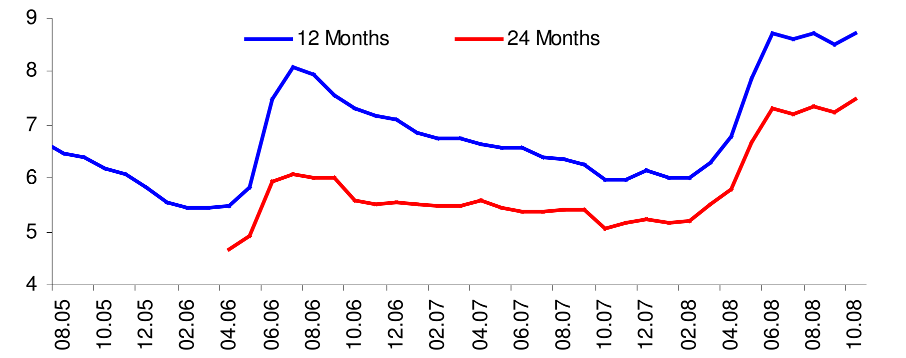
* As of August 2008.

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

Reaction of Monetary Policy

In order to contain the deterioration in inflation expectations and to prevent the materialization of the second round effects of supply-side shocks, the Monetary Policy Committee (MPC) implemented a monetary tightening during May-July period, increasing the policy rates by a cumulative of 150 basis points. The tightening in monetary policy, which was implemented jointly with the change in inflation targets, was effective in controlling expectations. Consequently, inflation expectations displayed signs of easing in the third quarter (Figure 6). The impact of the recent exchange rate depreciation on the medium term inflation expectations, on the other hand, is yet to be seen.

Figure 6: Inflation Expectations*



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

Despite the weakening domestic demand, uncertainties in the global financial markets have required monetary policy to remain cautious. The MPC has therefore decided to leave policy rates unchanged in the last three meetings (Table 1). In its latest statement, the MPC assessed that inflationary impact of the recent exchange rate movements would be offset by the favorable outlook in food prices and the sharp decline in oil prices. However, it was also noted that the intensification of the financial market turmoil required caution in terms of both the monetary policy and the inflation outlook.

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

Dates for MPC Meetings	Decision on Interest Rates	Interest Rate
January 17th, 2008	-0,25	15.50
February 14th, 2008	-0,25	15.25
March 19th, 2008	No Change	15.25
April 17th, 2008	No Change	15.25
May 16th, 2008	+0,50	15.75
June 17th, 2008	+0,50	16.25
July 18th, 2008	+0,50	16.75
August 14th, 2008	No Change	16.75
September 18th, 2008	No Change	16.75
October 22nd, 2008	No Change	16.75

Source: CBT.

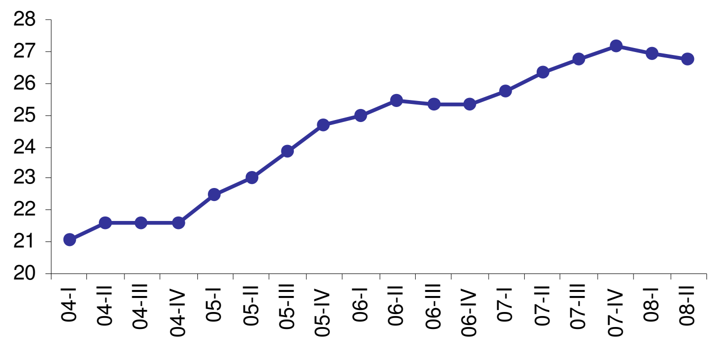
Inflation Outlook

Our forecasts in the July open letter envisaged a gradual recovery in the domestic economic activity throughout the forecast horizon. However, renewed tensions in global financial markets imply that the economic activity may continue to slowdown further. In fact, recent readings on domestic sales, production and confidence indicators suggest that the weakening in domestic economic activity has become even more significant since July (Figure 7).[1] As the world will feel the adverse effects of the intensified and prolonged financial market turmoil, both private

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

consumption and investment growth is likely to remain weak in the forthcoming period.

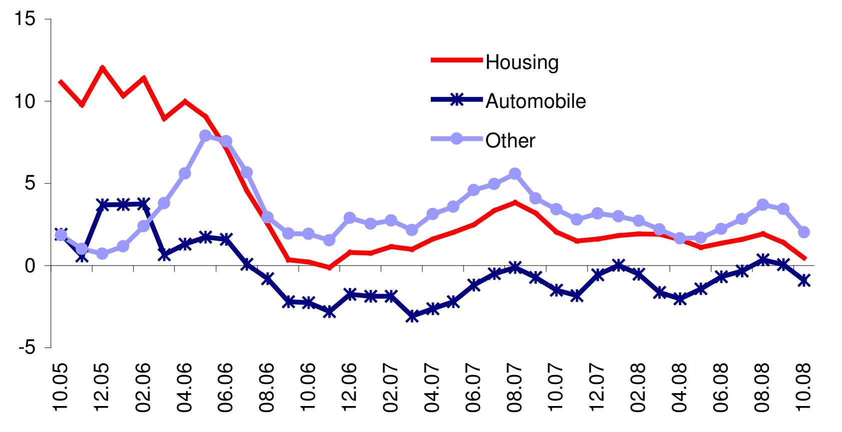
Figure 7: Final Domestic Demand
(Seasonally Adjusted, at 1998 prices, Billions, TRY)



Source: TURKSTAT, CBT.

Data on consumer credits suggest that financial conditions continue to be restrictive. Consumer loans in the past year have been growing at a moderate pace compared to the episodes of vigorous domestic demand (Figure 8). Recently, the slowdown in consumer loans has become more evident. Increased risk aversion and the tightening in credit conditions will continue to restrain credit growth in the forthcoming period.

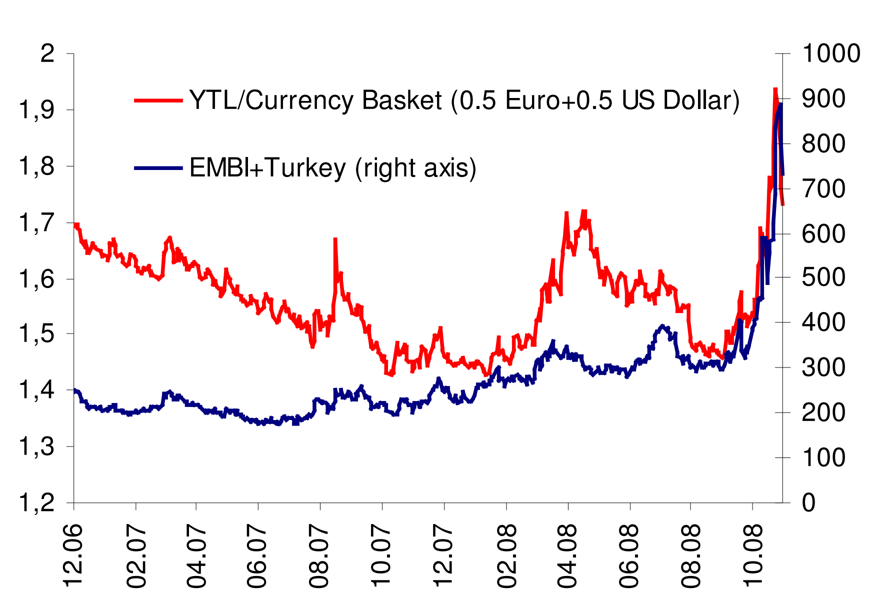
Figure 8: Consumer Loan Growth Rate*
(Month-on-Month, in real terms, 3-month moving average)



Source: TURKSTAT, CBT.
*October figure is forecast.

Longer-term interest rates have also increased significantly in response to heightened risk premium (Figure 9). Although higher interest rates contain domestic demand and support disinflation, the impact of rising uncertainties on the overall pricing behavior should be monitored closely.

Figure 9: Benchmark Interest Rate and Policy Rate

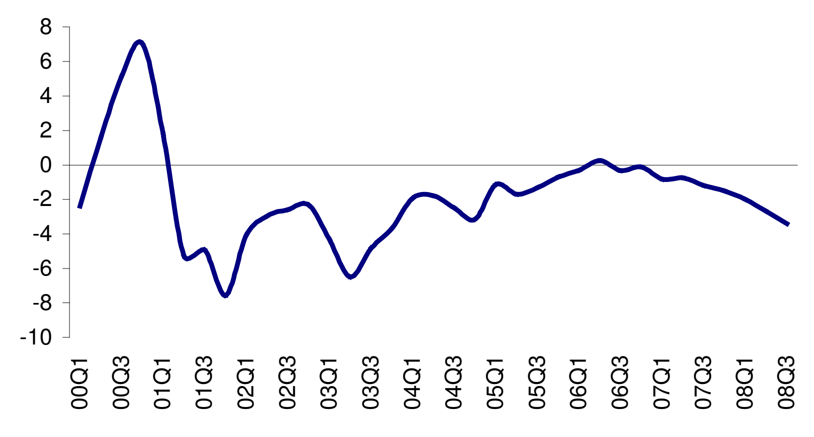


Source: CBT, ISE.

The expected weakening in the domestic demand and the recent depreciation in exchange rates will lead to a higher contribution fromnet exports on aggregate demand. However, this effect will be partly offset by the slowdown in external demand due to the economic downturn in our major trading partners.

Overall, we are likely to face a protracted period of weak domestic activity in the forthcoming period. Hence, our revised forecasts incorporate a larger contribution from aggregate demand conditions to disinflation, compared to the previous letter (Figure 10).

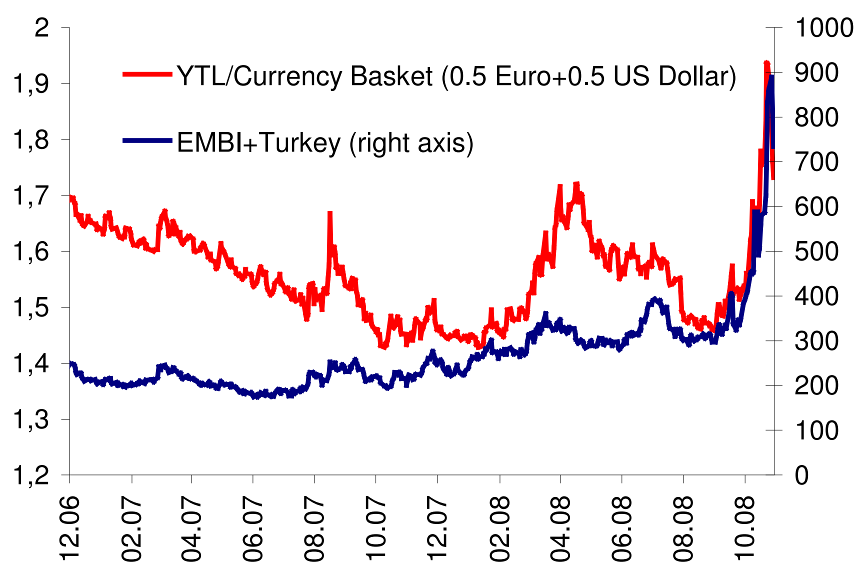
Figure 10: Output Gap



Source: CBT.

High level of uncertainty stemming from recent intensification of global financial market turmoil has led to an unusually high demand for USD liquidity, leading to significant depreciation of currencies in emerging markets, including Turkey (Figure 11). The significant slowdown in domestic demand growth should limit the second round effects of the exchange rate pass-through. Therefore, we expect the pass-through from exchange rates to the domestic inflation to be relatively limited compared to previous episodes. Still, first round effects of the recent depreciation is likely to add around 1,2 percentage points to 2008 end-year inflation and a further 1.5 percentage points to 2009 inflation.

Figure 11: Risk Premium and Nominal Exchange Rates



Source: CBT.

Baseline assumptions in the July Inflation Report envisaged a constant path for oil prices around USD 140 per barrel over the forecast horizon. However, oil prices displayed a sharp fall in the meantime, suggesting a downward revision in our assumptions. Taking the average future prices in the first three weeks of October as a benchmark, we have revised our baseline scenario for oil prices down to USD 80 per barrel. On the other hand, domestic prices of other energy items such as electricity and natural gas have increased at a faster pace than we expected, partly limiting the favorable impact of the fall in oil prices. Overall, the developments in energy prices has led to a downward revision in our end-2008 inflation forecast by 0.5 percentage points, and in our end-2009 forecast by 1.1 percentage points.[2]

Food prices also followed a more favorable course than implied by our baseline scenario in the July Inflation Report. Taking into account better than expected realizations in unprocessed food prices and easing agricultural commodity

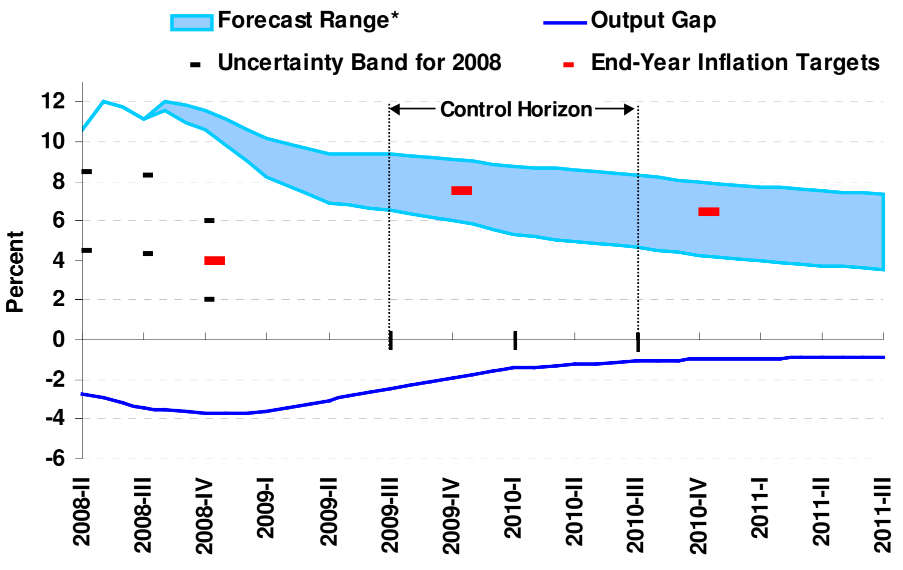
[2] Research conducted by our staff suggests that a 10 percent fall in oil prices leads to a reduction in annual inflation by around 0.4-0.5 percentage points in two years' time. October Inflation Report provides more details on this finding.

prices, we have lowered the assumptions for food inflation from 14 percent to 11 percent for the year 2008, and from 9 percent to 7.5 percent for the year 2009. These changes have led to a downward revision of about 0.8 points for 2008 and 0.4 percentage points for 2009. Moreover, we have revised our assumptions for 2010 food inflation down from 7 percent to 6 percent.

Services inflation turned out to be higher than expected in the third quarter, owing to the impact of the accumulated supply shocks on catering and transport services. This development has led to an upward revision of our end-2008 forecast by 0.6 percentage points. We expect services inflation to decelerate significantly in 2009 with the expected moderation in aggregate demand.

Accordingly, we have revised up our end-2008 inflation forecast to 11,1 percent. Our medium term forecasts suggest that, with 70 percent probability, inflation will be between 6.1 and 9.1 percent (mid-point 7,6) at the end of 2009, and between 4.3 percent and 7.9 per cent (mid-point 6.1) at the end of 2010. We forecast inflation to come down to 5.4 percent by the end of the third quarter of 2011 (Figure 12).

Figure 12: Inflation Forecasts*



Source: CBT

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

To sum up, there has been no major revision in our medium term inflation forecasts, as the impact of the favorable food and energy prices and the weakening demand on inflation will be largely offset by the pass-through from recent exchange rate depreciation.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in our policy stance. Given the exceptionally high level of uncertainties in global financial markets, monetary policy needs to remain flexible.

Risks

Recent problems in global credit markets have led to a loss of confidence in the global financial system. These developments have adversely affected the global liquidity flows and triggered an extraordinary demand for liquidity, especially in USD. Acting promptly and in a coordinated manner, central banks are taking decisions in an effort to overcome the liquidity squeeze in money markets. In line with these efforts, we have taken several measures to maintain the smooth functioning of domestic foreign exchange markets. First, the Central Bank of Turkey resumed its intermediary role in the Foreign Exchange Deposit Market. Second, we have suspended foreign exchange purchase auctions in order to further enhance the liquidity conditions of Turkish banks. Third, we have started to inject foreign exchange liquidity into the market through foreign exchange selling auctions to avoid undesired volatility in foreign exchange markets. We will continue to implement necessary measures to ensure the well functioning of financial markets in Turkey.

Looking ahead, credit conditions are expected to continue to tighten in the forthcoming period. Regarding the inflation outlook, these developments create upside risks through potential portfolio movements in the short term, but downside risks through weaker aggregate demand in the medium term. Given the uncertainty surrounding the global economic outlook, monetary policy needs to be flexible on either side. Therefore, future monetary policy decisions will depend on the impact of the ongoing financial turmoil on the domestic economy.

Commodity prices continue to be volatile, creating risks to the inflation outlook. Despite the downward revision in projections for food and energy prices, our main scenario is still based on quite conservative assumptions, implying that the risks are on both sides.[3] Should the upside risks materialize, monetary policy will be conducted so as to minimize deviations from the targets. Downward surprises in food and energy prices, on the other hand, will be perceived as an opportunity to bring inflation down at a faster pace than implied by our medium term targets.

Finally, a critical underlying assumption for the inflation and monetary policy outlook outlined above is that government expenditures and incomes policy 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 in place. In particular, this means any needed tightening in the fiscal balance would occur largely through expenditure cuts rather than higher excise taxes. Any deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

[3] In order to address these risks, October Inflation Report presents inflation projections under alternative scenarios for food and energy prices.

Conclusion

International markets have witnessed extraordinarily high level of volatility since the publication of the July open letter. This process has led to several significant changes in factors affecting inflation: First, recent depreciation in the Turkish Lira will create upward pressure on inflation, especially in the short term. Second, domestic demand conditions have been weaker than expected, implying larger contribution from aggregate demand conditions to disinflation compared to the previous letter. Third, with the sharp decline in commodity prices, we have revised down our assumptions for food and oil prices. We expect that the pass-through from recent exchange rate depreciation will be largely offset by the disinflationary impact of the favorable food and energy prices and the weakening aggregate demand.

Accordingly, our inflation forecasts suggest that inflation targets at 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 for food and energy prices. However, it should be noted that the intensification of the financial market turmoil requires caution with regard to both the monetary policy and the inflation outlook.

The Central Bank of Turkey has been closely monitoring the liquidity conditions in the domestic markets. We have taken several measures in order to facilitate the smooth functioning of our financial markets. We will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy. Future policy decisions will largely depend on the developments in global markets and their reflections on the local financial markets.

Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global financial turmoil. Preserving the fiscal discipline and strengthening the structural reform agenda would also help to mitigate the adverse effects of the ongoing shocks on the domestic economy. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance productivity gains, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.

We have also attached, for your consideration, our latest Inflation Report dated October 31st 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