CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2008-I

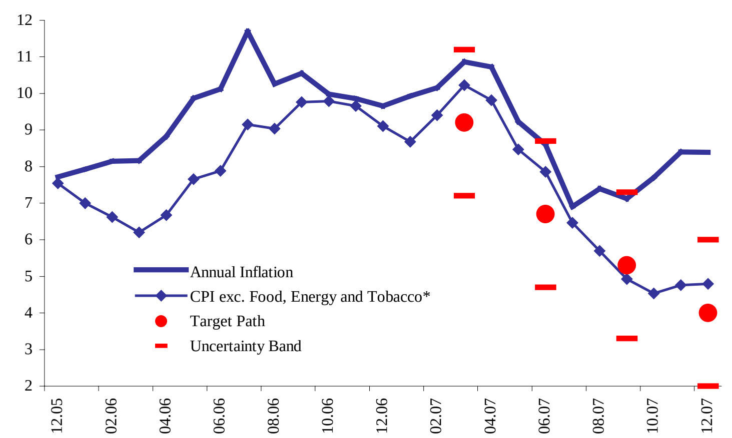
CONTENTS

1. Overview

1.1. An Assessment of the Year 2007

The monetary tightening exercised since mid-2006 has been successful in leading to a significant reduction in the underlying inflation. Especially the 3.6 percentage points fall in the services inflation, which confirmed the marked disinflation trend during 2007, was remarkable. The fall in headline inflation, however, was more limited, owing mainly to factors beyond the control of monetary policy, such as developments in food, energy, and administered prices. Accordingly, inflation was 8.39 percent at the end of 2007, breaching the upper bound of the uncertainty band. Inflation excluding food, energy and tobacco was at 4.8 percent (Graph 1.1.1).

Graph 1.1.1. Annual CPI Inflation and Target Path

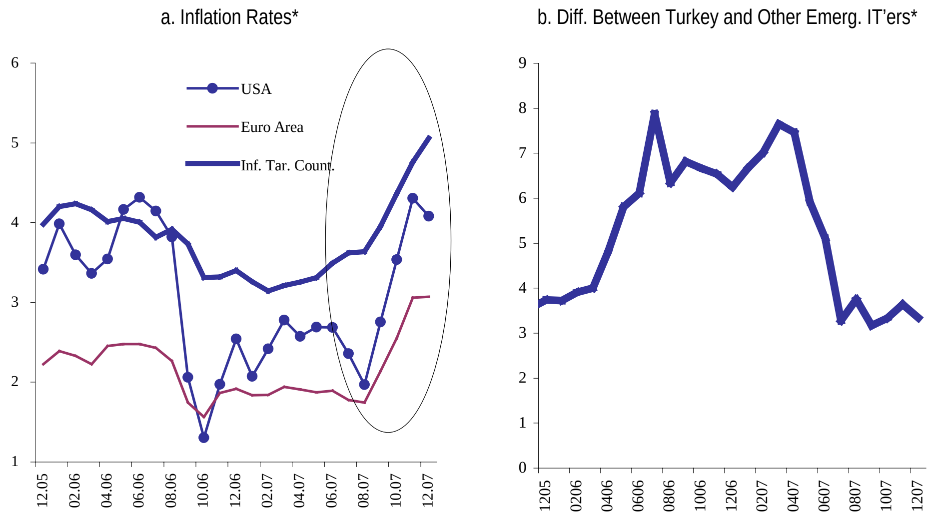


* "Food" item covers food and non-alcoholic beverages; "Tobacco" item covers alcoholic beverages and tobacco products.
Source: TURKSTAT, CBRT.

The course of food prices has been the main factor slowing down the disinflation process. A prolonged shortage of rainfall in Turkey since Autumn 2006 has resulted in low crop yields in 2007, which in turn translated to an adverse supply shock. Global developments, such as increasing bio-fuel production, strong global demand for food and consequent rises in agricultural commodity prices, further added to the domestic food inflation through the external trade channel. These factors had an impact not only on the prices of unprocessed food (such as fresh vegetables and fruit) but also on the prices of processed food (such as grain and dairy products). Accordingly, annual food inflation maintained its high levels, with an end-year figure of 12 percent. Hence, food prices became the main factor impeding the disinflation process in 2007, with a marked contribution of about 3.4 percent to headline inflation.

Another major factor slowing the disinflation process was adverse developments in energy and administered prices. The crude oil price in December 2007 was nearly 50 percent above the levels registered at the end of 2006. This development, together with changes in the special consumption tax on fuel-oil products, led to a significant rise in prices of fuel-oil products in 2007. Another energy item, housing water prices, which is administered by municipalities, edged up in the last quarter of 2007, partly owing to drought conditions. Overall, 1.6 points of the headline inflation resulted from the energy price hikes, where the contribution of administered component outweighs that of the oil price.

Graph 1.1.2. International Developments in Inflation: Inflation in USA, Euro Area and Inflation Targeting Emerging Economies



*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 related central banks.

Elevated prices of crude oil, agricultural products and other commodities have continued to exert inflationary pressures all over the world. Recently, both the developed and emerging economies have been facing a rise in inflation (Graph 1.1.2). Inflation in Turkey followed a more favorable trend in 2007 compared to other emerging economies under inflation targeting, notwithstanding the administrative price hikes in November, which added by about 1-percentage point to the Turkish CPI inflation. During the past year, inflation in Turkey declined from 9.7 percent to 8.4 percent, while the average of inflation in emerging market economies under inflation targeting rose from 3.4 percent to 5.1 percent.

Despite the adverse developments on food and energy prices, the significant deceleration in core inflation set the ground for a relatively less restrictive monetary policy. Accordingly, the Monetary Policy Committee (MPC) decided to start a measured easing cycle in September 2007 with a 25 basis points cut, while continuing with 50 basis points in the consecutive three meetings. The MPC underscored that monetary policy remained restrictive even after these rate cuts. However, the MPC also underlined the need to remain cautious against the risks related to potential second round effects of food and energy prices—as manifested in the sticky inflation expectations; and reduced the pace of rate cuts in January 2008. Consequently, policy rates were lowered by 200 basis points in the period between September 2007 and January 2008.

1.2. Inflation Outlook

Domestic demand conditions continue to support disinflation. The sharp slowdown in the second half of 2006 created an ample slack in the economy. Although domestic demand showed some signs of recovery in the second half of the year 2007, the pace of the economic activity does not appear to be fast enough to eliminate the output gap. Moreover, the uncertainty created by the ongoing difficulties in the mature credit markets is expected to hold back the domestic consumer and investment spending in the forthcoming period. Accordingly, our medium term projections are constructed under the assumption that demand and capacity conditions will contribute to the disinflation process throughout 2008.

Monetary conditions continue to support the disinflation process. Despite the recent rate cuts, monetary policy can still be considered to be in the restrictive territory. Underlying rate of monetary expansion remains modest, consistent with a relatively restrictive monetary stance. Although medium term interest rates followed a downward trend in the past quarter, 2-year real rates at this point fluctuate between 9 and 10 percent, implying a non-accommodative monetary stance. Moreover, the currency remains strong, curbing inflationary pressures and easing the impact of rising commodity prices on domestic production costs.

External demand conditions are also expected to contribute to disinflation in 2008. Recent data on global activity suggest that world economic growth is likely to moderate in the forthcoming period, increasing the downside risks on external demand. Accordingly, our medium-term outlook is constructed under a baseline scenario of gradual slowdown in external demand.

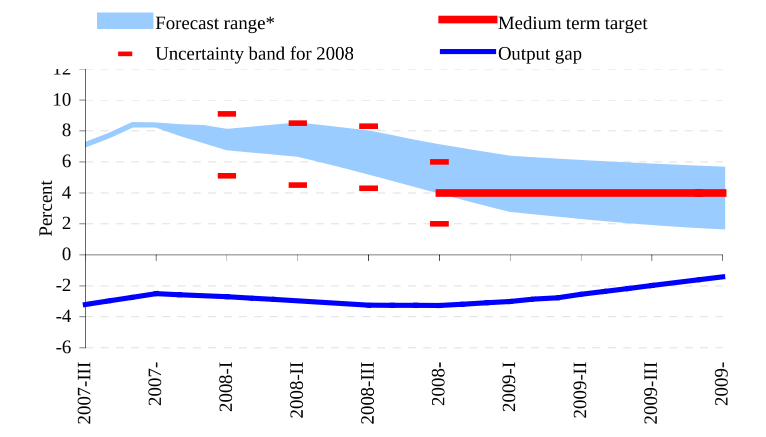
Overall, we expect aggregate demand conditions to support the downward trend in the underlying inflation, i.e., inflation excluding items beyond the control of monetary policy such as energy, food and tobacco prices. Hence, barring new supply shocks, headline inflation should continue to move towards the target. The speed of the convergence to the target, however, will depend mainly on the course of food and energy prices.

Our forecast in the 2007 October Inflation Report incorporated two main assumptions. The assumption for oil price was set as 70 USD per barrel. Observing the high base created by the unusually elevated food prices in 2006, we assumed food inflation to correct towards the values consistent with medium term inflation in 2007. However, food and energy inflation turned out to be more persistent than we had envisaged, as the prices of oil and agricultural commodities continued to rise throughout 2007. These developments not only led to an undershooting of our inflation projections for end-year 2007, but also necessitated an upward revision in our medium term forecasts.

Accordingly, we revised our assumption for oil prices to 85 USD per barrel in 2008. Higher oil price assumption added about 0.5 percentage points to the end-2008 inflation forecasts. Moreover, the first round impact of the recent hikes in end-user electricity and natural gas prices is computed to be around 0.6 percentage points, which is higher than we assumed in the previous Inflation Report. We have also revised our projections up for the food inflation. We now envisage that the lagged impacts of last year’s drought and elevated prices of agricultural commodities in global markets are likely to keep processed food inflation at relatively high levels throughout 2008.

Upside revisions on the assumptions for food and energy inflation imply that it may take longer to bring headline inflation to 4 percent than envisaged in our previous Inflation Report. Therefore, in the absence of a significant correction in food inflation, headline inflation will most probably exceed the target level of 4 percent at the end of 2008.

Graph 1.2.1. Forecasts for Inflation and Output Gap



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

Accordingly, we forecast inflation, with 70 percent probability, to be between 4.1 percent and 6.9 percent (midpoint 5.5) at the end of 2008, and between 1.8 percent and 5.5 percent (midpoint 3.7) at the end of 2009 (Graph 1.2.1). The forecast is based on a scenario in which policy rates display a limited decline in 2008. Main message of the forecast is that continuation of the gradual easing cycle that started in September 2007 will remain conditional on favorable data and developments. In that sense, the current policy stance envisages a more moderate decline in policy interest rates than indicated in the previous Inflation Report.

It should be emphasized that any new data or information on the inflation outlook may lead to a revision in the policy stance. Therefore, the policy path indicated above should not be perceived as a commitment on behalf of the Central Bank of the Republic of Turkey (CBRT).

1.3. Risks and Monetary Policy

There are both upside and downside risks to the inflation and monetary policy outlook:

The main upside risk factor for the current medium term inflation outlook pertains to the potential second round effect of the accumulated supply shocks, which may also create a higher than expected inflation inertia, as currently manifested in the medium term inflation expectations. So far, the second round impact of food prices has been limited and confined to selected sub-components of the overall index such as restaurants and catering services. The potential second round impact of elevated food and energy prices, however, should not be overlooked. Therefore, the CBRT will keep a close eye on the price setting behavior along with various core inflation measures. The policy strategy will be to tolerate the first-round impact on inflation resulting from food, energy and one-off adjustments in administered prices, yet to remain responsive to the second round effects.

The CBRT closely monitors the developments in global markets. The potential impact of ongoing difficulties in the US credit markets, on the financial markets and the real economy, continue to create uncertainty about the course of the global economy. Our baseline scenario assumes a soft landing in developed economies, with no major portfolio shock on the Turkish financial markets. However, the probability of a sharper than expected slowdown should not be ruled out. While the possibility of a sharper than envisaged slowdown in global economic activity, through a portfolio shock and its potential impact on the exchange rates, may constitute an upside risk for the short-term inflation outlook, it also poses downside risks for inflation in the medium term through a possible weakening in external demand and domestic credit.

It should be underlined that fiscal discipline of the past several years, by reducing the long-term risk premium, has been the key force allowing the achievement of robust output growth during a remarkable disinflation period. Maintaining the prudent fiscal policy, during an episode of worsening risk appetite, is even more critical in preserving the resilience of the economy.

Our medium term projections are based on the assumption that government expenditure targets will be met in 2008. Moreover, we assume that any extra need to readjust the primary budget balance will be implemented primarily through expenditure cuts rather than hikes in indirect taxes. Therefore we envisage no major shocks arising from administered price adjustments, except the hikes in electricity and natural gas in January 2008. Any deviation from this assumption may alter the inflation and monetary policy outlook.

The recent increase in end-user energy prices may continue to exert some temporary upward pressure on headline inflation in the coming months. However, these adjustments will also support lower inflation in the medium term as they contribute to a prudent fiscal stance and facilitate an expansion of the domestic energy production. Hence, the CBRT will not react to these price adjustments, except to contain second-round effects.

Developments in food prices are still considered as an important risk to the short-term inflation outlook, as food items constitute more than one fourth of the CPI basket. The course of food inflation is highly dependent on domestic weather conditions as well as global developments. In the medium term, there is a significant chance of a downward correction in unprocessed food inflation, especially given the base effect created by the last two years' elevated food prices. On the other hand, it is also possible that global developments and increasing demand for certain food items may continue to push up the food prices. Therefore, food prices continue to pose risks to the inflation outlook on both sides.

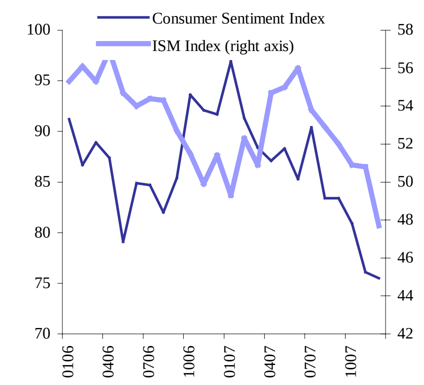
So far, Turkish economy has been resilient to reappraisal of risks in global financial markets. The support from fiscal policy and structural reforms are critical in shielding the economy against possible further deterioration in global sentiment. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain crucial. In particular, advances in structural reforms enhancing quality of fiscal discipline and raising productivity are monitored closely by the CBRT with regard to their implications on macroeconomic and price stability.

2. International Economic Developments

2.1. Economic Performance and Monetary Policy

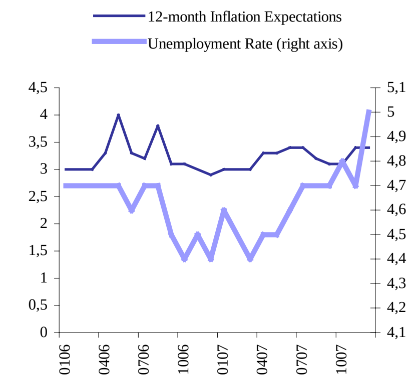
The US economy grew at 1.5, 1.9 and 2.8 percent, respectively, in the first, second and third quarters of 2007 (Table 2.1.1). As stated in the Inflation Report of October 2007, rising concerns over the sub-prime mortgage credits led to a turbulence in the financial markets in August 2007, which hit both the housing and credit markets before they rebounded in late September. However, the uncertainty surrounding the outlook for economic growth has increased as the market turmoil flared anew in November. In fact, the plunge in the University of Michigan Consumer Sentiment Index during the recent months of the year 2007 suggests that consumers are becoming increasingly pessimistic about personal consumption and business conditions in the year ahead. The Institute for Supply Management Purchasing Managers' Index (ISM) also displayed a similar downward trend (Graph 2.1.1).

Graph 2.1.1. University of Michigan Consumer Sentiment Index and ISM Index



Source: Bloomberg, Institute for Supply Management.

Graph 2.1.2. Unemployment Rates of American Economy and Expectations (Percent)



Source: Bloomberg.

Moreover, the recent jump in the unemployment rate, the steep correction in the US sub-prime mortgage market, the slump in investment and consumer spending, the tightening of credit conditions and deteriorating balance sheets of financial institutions strengthen the possibility of a recession in the US economy in the upcoming period (Graph 2.1.2). In sum, credit markets have been distressed by a liquidity squeeze in parallel to the sub-prime mortgage problems, and the extent to which the financial market tensions will spill over into the rest of the economy and affect overall growth still remains uncertain.

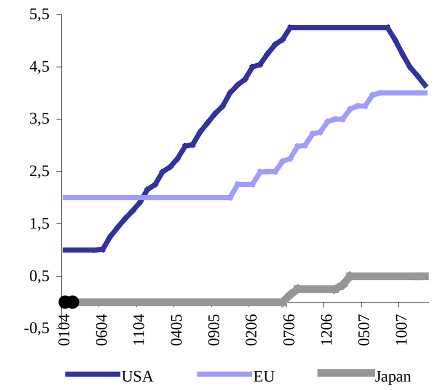
Table 2.1.1. Growth Rates
(Annual Percentage Change)

	2007*	2008*	2007-I	2007-II	2007-III	2007-IV*
World	5.2	4.8	-	-	-	-
USA	2.2	2.0	1.5	1.9	2.8	2.5
England	3.1	1.8	3.1	3.1	3.2	2.7
Asia-Pacific						
Japan	1.9	1.5	2.8	1.6	2.0	0.9
China	11.4	10.7	11.1	11.9	11.5	-
Eurozone						
Germany	2.5	1.8	3.6	2.5	2.5	1.9
France	1.9	1.7	1.9	1.4	2.1	2.1
Italy	1.8	1.2	2.4	1.8	1.9	1.1

* Forecast.
Source: Consensus Forecasts, OECD, IMF, China National Statistics Bureau.

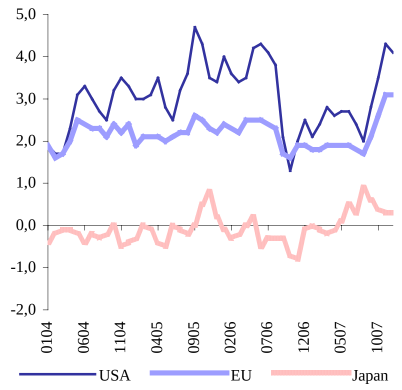
In the face of credit crunch, the US Federal Reserve (Fed) has cut the federal funds rate by a cumulative 175 basis points since September to 3.5 percent (Graph 2.1.3). Moreover, in Fed's press release of December 12, 2007, it is declared that the Fed, in coordination with the Bank of England (BoE), the European Central Bank (ECB), the Bank of Canada (BoC) and the Swiss National Bank (SNB) decided to implement the Term Auction Facility (TAF) to ease short-term funding requirements of banks, and by doing so, to provide liquidity into related countries' domestic markets. Accordingly, the Fed injected USD 40 billion liquidity in December 2007 and decided to provide USD 60 billion in January. It is also announced, in the same press release, that reciprocal currency arrangements (swap lines) between the Fed, the ECB and the SNB have been established so that the dollar liquidity need in international markets would be met by providing USD-denominated financial assets in exchange for financial assets in euro and other currencies.

Graph 2.1.3. Monetary Policy Interest Rates*
(Percent, Monthly Average)



* As of January 23, 2008
Source: Bloomberg.

Graph 2.1.4. Inflation Rates
(CPI, Annual Percentage Change)



Source: Bloomberg.

The rate cuts that aim to ease the credit crunch come in an environment of continued upward pressure on inflation. In fact, while core inflation remained relatively stable throughout 2007, increased energy and commodity prices continued to put pressure on inflation (Graph 2.1.4). Besides, the deterioration in inflation expectations suggests that the upward pressure on inflation will most likely remain (Graph 2.1.2). Furthermore, the decision taken to lower the federal funds rate by 75 basis points in the unscheduled Federal Open Markets Committee (FOMC) meeting on January 22, 2008 has reinforced the expectation that Fed will be even more aggressive in cutting interest rates to help alleviate concerns over growth instead of leaving rates steady to curb inflation. Together with this rate cut decision, if the Fed continues with these sooner- and larger-than-expected rate reductions, real interest rates will inevitably turn negative. Under these circumstances, the fact that the flexibility of monetary policy is not wide enough in the face of the possibilities that the US economy would fall into recession in an inflationary environment as well as crunch in the credit markets could not be avoided to the desired extent is considered as a serious problem; and thus, at this stage, it is suggested that expansionary fiscal policies should also be pursued. As a matter of fact, in testimony before the Congress' Joint Economic Committee on January 17, 2008, the Fed Chairman Ben Bernanke called for an immediate "fiscal stimulus package". On January 18, 2008, the US President George W. Bush signaled that the stimulus package might be USD 145 billion worth of tax relief, which amounts to approximately 1 percent of GDP.

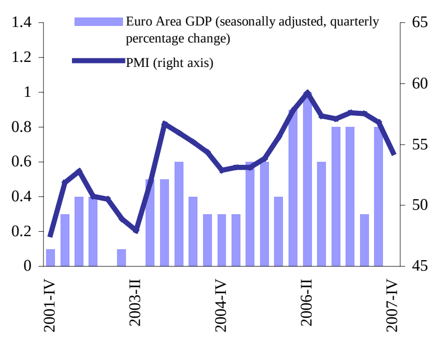
In addition, the prospect of the US current account deficit and the US dollar is another source of uncertainty over the US economy. The US current account deficit continued to narrow in the third quarter of 2007, declining to 5.1 percent of the GDP. Although the rate of depreciation of the US dollar has diminished, the still-strong global demand helped further the decline in the current account deficit. On the other hand, in a case of further deterioration of the global financial conditions, the subsequent course of global demand and the US dollar may aggravate the US current account deficit.

Under current circumstances, it is expected that expectations and developments related to the US economy will shape the global developments to a major extent, while contribution of the other countries to global developments will depend on the extent to which their economies are affected by developments in the US economy. In other words, the global economic developments will be largely influenced by how European and Asian markets will react to developments in the US economy. Therefore, in this period, these economies should be examined not only from a local perspective but also from a perspective addressing the spillover effects from the US economy.

In this framework, as regards the euro area economies, notwithstanding the volatility in the financial markets, the said countries have not experienced crunch in their credit markets and the third-quarter growth rate was close to the potential rate. Since profitability has increased, employment growth has been robust and the unemployment rate has fallen to a 25-year low, regional factors will be less likely to pose risks to euro-area growth in the next period. On the other hand, the potential US economic recession as well as the uncertainties surrounding crude oil, food and base metal prices have heightened the risk perceptions related to non-regional factors on Euro area growth. In this sense, although it is projected that the euro-area growth in 2008 and 2009 will be close to the potential rate, in the face of a recession in the US economy, it is quite probable that the projected Euro area growth will not be realized. In fact, the Euro area PMI index moved parallel to the GDP data and displayed a similar pattern as the US ISM index (Graph 2.1.5, Graph 2.1.6).

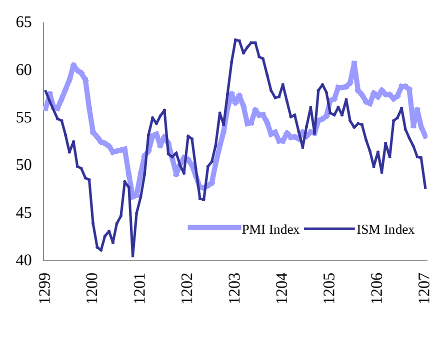
The Euro area Harmonized Index of Consumer Prices (HICP) inflation in December 2007 confirmed the existence of strong short-term upward pressure on price stability (Graph 2.1.4). A larger-than-expected money and credit growth is forecast to result in increased inflationary pressures over the medium to longer run.

Graph 2.1.5. Euro Area GDP and PMI Index



Source: Bloomberg, Eurostat.

Graph 2.1.6. PMI and ISM Index



Source: Bloomberg.

In January 2008, the ECB Governing Council, although noted upside risks to price stability over the medium term with a more forceful tone than the previous months, left key interest rates unchanged (Graph 2.1.3). Yet, the ECB also added that they expect the inflation to remain above the 2-percent target during 2008, keeping its upward trend. This scenario is based on three factors: firstly, as a result of favorable trend in labor markets as well as secondary effects of increases in crude oil and food prices, rises in wages might be greater than expected. The second one is the heightened concern over the price-setting behavior of less competitive firms. The last factor is the uncertainty about crude oil and food prices as well as increases in administered prices and indirect taxes in the Euro area beyond expectations. Moreover, the ECB also indicated, with particular reference to the wage negotiations in Germany, that they will act preemptively to avoid secondary effects on price stability. On the other hand, despite fears of inflationary pressures, the ECB has committed, in conjunction with the Fed, to conduct two auctions that amounted to USD 10 billion each in January, in order to satisfy the US dollar liquidity requirements in the money market.

The Japanese economy grew at an annual rate of 2.8, 1.6 and 2 percent, respectively, in the first three quarters of 2007 (Table 2.1.1). The main reason for the slowdown in the Japanese economy was – in addition to a stagnation in the world economy, particularly in the US economy – decreases in housing investments (by 11.3 percent) and fixed capital expenditures (by 1.3 percent). The tension in credit markets due to global economic downturn made Japanese companies act more cautiously and cut their capital expenditures, while the introduction of new construction safety codes delayed new project starts. Despite the slump in investment spending, the 27.5 percent increase in net exports, driven by the increasing demand from Asia, decelerated the downward trend in GDP growth.

Consumer prices in Japan went down by 0.1 percent in the first nine months of 2007, mainly on the back of falling prices of furniture and household utensils. In the last quarter of 2007, however, increasing energy and transportation costs helped consumer prices rise at a benign rate as expected. Besides, the growing industrial production, up 2.8 percent as compared to the first half of the year and the falling unemployment rate, down 3.8 percent, suggest further rebound in consumer spending. On the other hand, expectations of a continued increase in energy prices on the basis of global developments strengthens the expectations that consumer prices will rise further (Graph 2.1.4).

The Bank of Japan (BoJ) indicated that, despite a sluggish housing market, rising energy prices and global economic uncertainties, the Japanese economy expanded at a moderate pace due to continued global economic growth; the companies did not face any pressure to adjust their capacities; and the slowdown in the housing market was temporary; and, against this background, decided to keep its overnight call rate unchanged at 0.5 percent (Graph 2.1.3).

China's annual inflation rate jumped to 6.5 percent in October and further to 6.9 percent in November mainly on skyrocketing food prices due to high temperatures and severe drought. Not only the inflation rate but also the housing prices that hit a 6-year high of 6 percent suggest that the economy will continue to heat up. In this regard, the People's Bank of China (PBC) declared that it will shift its monetary policy from "prudent" to "tight" in 2008 and raised the one-year deposit rate by 27 basis points to 4.14 percent at its late-December, 2007 meeting. The bank also announced that it would hike the reserve requirement ratio by 50 basis points to 15 percent, effective January 25, 2008.

Based on interest rate hikes and a possible recession in the US, a major trade partner of China, a slowdown in Chinese export and a consequent decrease in economic growth is expected. Accordingly, the Chinese economy is expected to grow at 11.4 and 10.7 percent in 2007 and 2008, respectively.

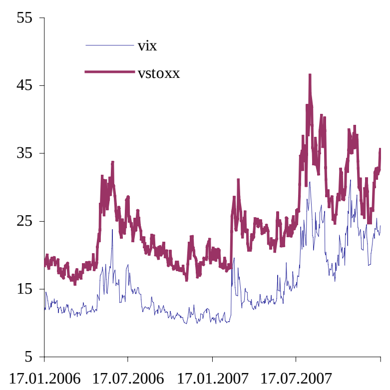
In sum, the global economic outlook for 2008 will primarily depend on a possible US recession and the role of European and Asian markets in diminishing the impacts of this probable recession. Until the last financial market turbulence in November 2007, it was widely believed that European Union (EU) member states would relatively be insulated from a recession in the US, and Asian countries would maintain their strong growth rates, thereby keeping the world economy afloat. Under the current circumstances, however, a possible US recession may put downward pressure on Asian exports and a weaker dollar might further reduce export revenues of the said countries based on the fact that Asian markets, particularly China, are net exporters to the US. In addition, the signs of monetary tightening against overheating of the Chinese economy might cause growth rates to fall more drastically. Besides, the repeated downward revisions of EU countries' growth forecast figures since November 2007 signify the possibility that the EU will also be affected negatively by a possible recession in the US economy. In this framework, in the face of a possibility that the Asian economies might accompany the negative developments in the US economy, the future trend of oil prices, our foremost concern, and of energy and commodity prices will be closely monitored to better understand the impacts of a possible US recession on the rest of the world.

2.2. International Markets

2.2.1. Financial Markets

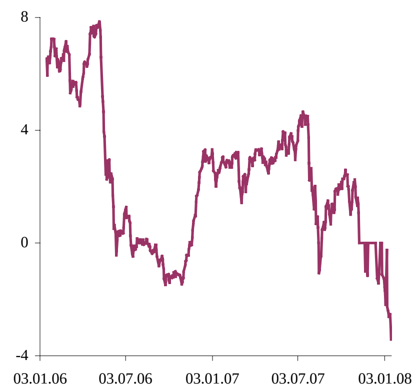
Financial markets performed poorly during the last quarter because the crisis in the US money and credit markets that emerged last summer crawled into real economy notwithstanding the attempts of central banks of developed economies to stave off a further collapse and led to fears of recession in the US economy. During this period, investors mostly preferred risk-free instruments, while emerging market economies were relatively less affected by the global financial turmoil.

Graph 2.2.1. VIX and VSTOXX Indices



Source: Bloomberg.

Graph 2.2.2. Credit Suisse Global Risk Appetite Index



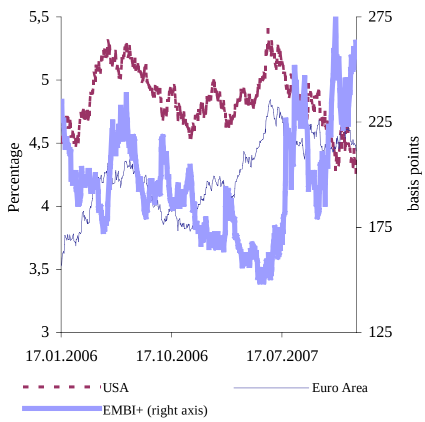
Source: Credit Suisse.

The Credit Suisse Global Risk Appetite Index (CSRA), signaling the reduced appetite for risk, has entered the panic zone for the first time since October 2002.[1] VIX and VSTOXX indices remained on an upward track throughout 2007, ultimately exceeding their 5-year average, and also signaled lower risk appetite, though not as sharp as the CSRA index (Graph 2.2.1, Graph 2.2.2).

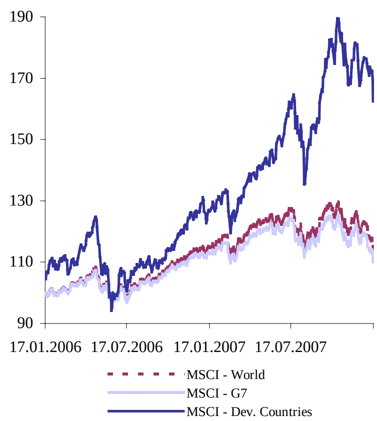
[1] Values below “-3” correspond to the panic zone while values above “5” correspond to the euphoria zone.

As regards bond markets in developed economies, the first thing to note is the decline in long-term US Treasury bond yields resulting from both the expected slowdown in the US economy and the search by investors for safe havens. The bond market in the Euro area, on the other hand, seemed relatively restrained. In the fourth quarter of 2007, 30-year US Treasury bond yields were down by 78 basis points as compared to the second quarter and down by 38 basis points as compared to the third quarter, while eurobond yields registered a decline by 10 basis points with respect to the second quarter, but an increase by 2 basis points from the third quarter. As to emerging markets, the EMBI+ index widened by 64 and 26 basis points during the same period. While the increase in EMBI+ was mostly attributable to falling US bond yields, in the beginning of 2008, bond markets in all three regions seem to follow a similar pattern (Graph 2.2.3).

Graph 2.2.3. Government Bond Markets



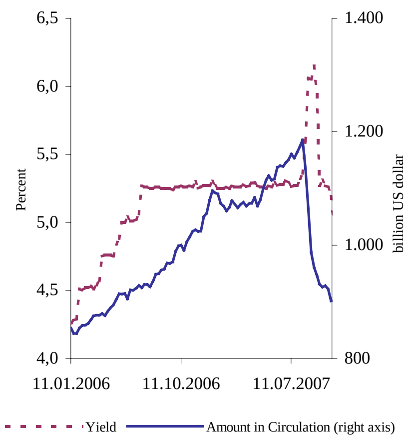
Graph 2.2.4. Equity Markets



Source: Bloomberg.

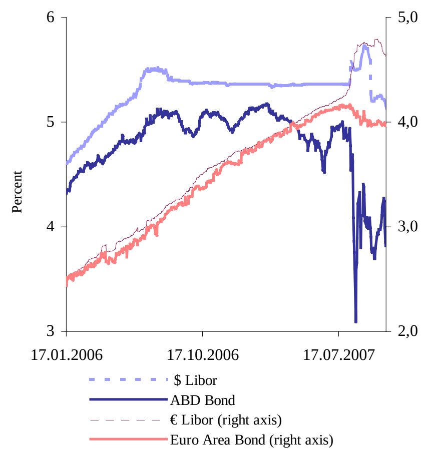
The upward trend in stock markets has also reversed. During the last quarter, the Morgan Stanley (MSCI) G7 Index went down by 2.9 percent from the third quarter and by 1.7 percent from the second quarter, while the MSCI Emerging Markets Index (EEM) was up by 3.4 and 17.5 percent in dollar terms. Nevertheless, the decline in returns due to the negative economic outlook for industrialized countries and a reduced risk appetite became even more pronounced by mid-January, and both indexes fell by 7.2 and 7.9 percent, respectively (Graph 2.2.4).

Graph 2.2.5. USA Asset-Backed Commercial Paper Market Developments



Source: Bloomberg, Fed.

Graph 2.2.6. USA and Euro-Zone Interbank Rates and Treasury Yields (3-month)



Source: Bloomberg.

The Asset-Backed Commercial Paper (ABCP) Market, a valuable source of liquidity for investment companies, has significantly shrunk due to the US sub-prime turmoil, and yields have thus risen strongly. After surging to a record USD 1.2 trillion in the first week of August, bonds in circulation started to plunge and declined to USD 800 billion at the end of 2007 (Graph 2.2.5). The contraction of the ABCP market was a major driver of the liquidity crisis and rate hikes in money markets. As a matter of fact, the spread between the US dollar LIBOR (London Interbank Offered Rate) rates and the US treasury bond yields widened to over 200 basis points in mid-December, and was back on a downward track following the coordinated liquidity injections by the central banks of the developed countries. The euro market has shown a similar pattern to the US market, but with less dramatic changes, and the spread between euro-LIBOR and euro-denominated treasury bond yields increased to 117 basis points at most. The money market squeeze added to the weak performance of financial markets by raising funding costs and uncertainties (Graph 2.2.6).

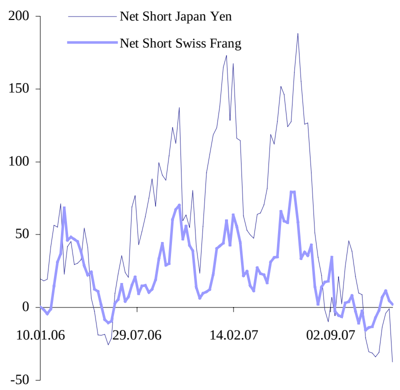
Table 2.2.1. Industrialized Countries Interest Rate Developments* (3-months)

	2008				
		Futures			
	Spot	**March**	**June**	**September**	**December**
US dollar	3.92	3.58	3.10	2.90	2.82
Euro	4.51	4.33	4.08	3.89	3.76

* 3-month futures contracts, as of 16th January. For US dollar, spot rates are taken from Eurodollar market, while futures rates are CME Eurodollar futures rates. For the Euro-zone spot rates are taken from Euribor market, while futures rates are LIFFE futures rates.
Source: Bloomberg.

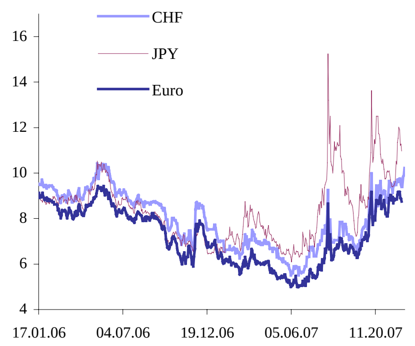
As suggested by the futures markets, both US dollar and euro interest rates are expected to decline in 2008. As the US dollar interest rate in the spot market ran below the federal funds rate, many believe that Fed will cut rates again at its end-January meeting and expect a string of rate cuts over the first three quarters of the year (Table 2.2.1).

Graph 2.2.7. Yen and Swiss Frank Net Short Positions
(Non-commercial Investors, Chicago Mercantile Exchange)



Source: Bloomberg.

Graph 2.2.8. Implied Volatilities Between US dollar and Yen, Swiss Frank, Euro



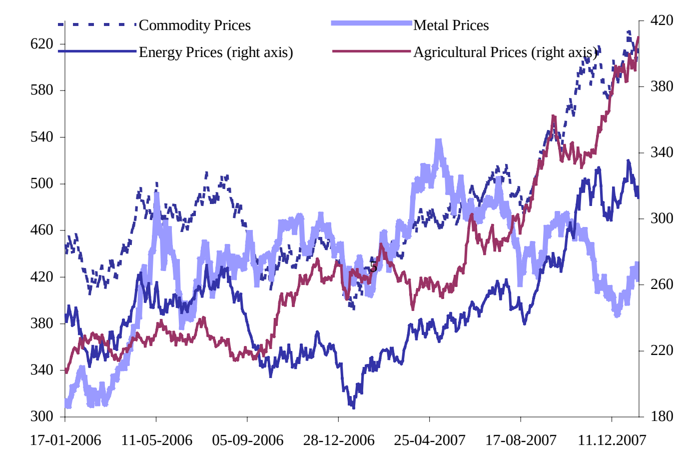
Source: Bloomberg.

As regards carry trade, which has been an important source of liquidity for investors recently, speculators have considerably narrowed their JPY and CHF positions due to concerns about financial markets (Graph 2.2.7). The upward trend in implied volatilities that started in mid-2007 makes carry trade riskier. The current trend of these currencies suggests that carry trade will become less appealing in the upcoming period.

2.2.2. Commodity Markets

During the first fifteen days of January, the Goldman Sachs (GS) Commodity Index continued to be on the upward trend, increasing by 51.1 percent as compared to the same period of 2007, on the back of GS Energy and GS Agriculture sub-indexes representing an increase of 46.4 and 7.5 percent, respectively. GS Metals index, on the other hand, remained flat (Graph 2.2.9).

Graph 2.2.9. Commodity Prices



Source: Goldman Sachs.

The GSCI Industrial Metals index made up 7.6 percent of the total GSCI index, with copper, aluminum and nickel together accounting for a substantial 6.5 percent share in the main index. In this context, the prices of these three base metals traded on the London Metal Exchange (LME) rebounded at the turn of 2008 after a sharp drop in the fourth quarter of 2007 (Table 2.2.2). Although the surplus in copper, aluminum and nickel supply, resulting from a marked production growth, helped lower their prices in the fourth quarter of 2007, the recently increased inflation rate gave a temporary boost to base metal prices (Table 2.2.3). On the other hand, in the face of the possible US mortgage market-led slowdown in global economic growth and the positive growth trend in base metal inventories, the rate of increase in the base metal prices is expected to slowdown in the upcoming period.

Table 2.2.2. London Metal Exchange (LME)*

Tons/USD	**Value**				**Percentage Change**		
	2006-IV	**2007-III**	**2007-IV**	**2008-I****	**2007-IV/2007-III**	**2007-IV/2006-IV**	**2008-I**/2007-IV**
Aluminum	2.803	2.520	2.409	2.485	*-4.4*	*-14.1*	*3.2*
Copper	6.330	8.020	6.675	7.160	*-16.8*	*5.5*	*7.3*
Nickel	33.325	30.500	26.300	28.450	*-13.7*	*-21.1*	*8.2*

* Table shows end of period values.
** As of January 15, 2008
Source: Bloomberg.

Table .2.2.3. Base Metal LME Stock Values*

	2006		**2007**				**2008**
	December	*Average*	January	September	December	*Average*	January**
Copper	182.200	106.004	213.675	130.775	197.450	158.515	194.100
Aluminum	699.325	781.241	736.875	938.625	930.025	841.948	941.225
Nickel	6.648	13.477	3.972	32.442	47.946	17.944	46.692

*Thousand tons for base metals from LME
** As of January 15, 2008
Source : Bloomberg.

International crude oil prices hit a historic peak of 97.8 US dollar per barrel on January 2, 2008. Brent crude oil prices decreased slightly thereafter to 88.6 US dollar per barrel on January 16, 2008 (Graph 2.2.10). The continued sizeable decline in the US and OECD oil stocks, the renewed geopolitical uncertainties in Nigeria, and the shortage of crude oil stocks in China due to record production in the past period have been the key factors behind the rise of crude oil prices, but fears of a weakening US economy have helped crude oil prices to retreat from an all-time high (Table 2.2.4). Furthermore, according to the oil market report released by the International Energy Agency (IEA) on January 16, 2008, oil demand is revised down by 0.13mb/d in the face of an impending slowdown in the US economy which has significantly reduced the upward pressure on oil prices.

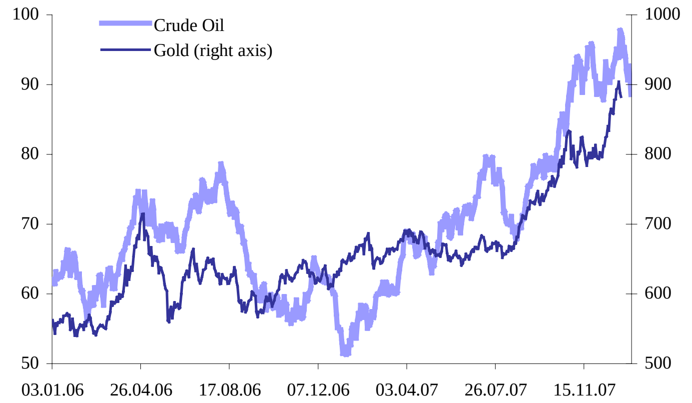
Table 2.2.4. Crude Oil Market *

	2006		2007				2008
	September	December	March	June	November	December	January**
Total Stocks (thousand barrel)	1,776.4	1,712.5	1,670.8	1,716.8	1,697.3	1,671.0	1,668.2
Product	760.5	704.2	649.4	672.5	696.7	685.0	683.0
Strategic Reserve	687.8	688.6	688.7	690.3	695.4	696.4	698.1
Crude Oil	328.1	319.7	332.7	354	305.2	289.6	287.1
Crack Spread (USD/barrel)	2.4	6.8	20.6	23.5	5.0	8.6	5.1
Non commercial Net Long Pos. (Thousand contract)	13.69	19.85	40.20	67.16	59.10	52.85	94.92

* End of period values. Stock figures are US data. Net positions are NYMEX figures.
** Stock figures as of January 11, crack spread as of January 15, net position figures as of January 8 figures.
Source: Bloomberg, www.doe.gov.

The need for warmth caused a seasonal surge in crude oil consumption during the previous quarter. Sudden supply-cuts, driven by geopolitical concerns and the lack of idle capacity in the crude oil market put upward pressure on crude oil prices, which has aggravated the pressure through attracting speculators. Therefore, the sizable net long positions of speculators in the highly vulnerable crude oil market added to the rising trend of crude oil prices (Table 2.2.4). Thus, the extent to which the US slowdown will affect the rest of the world, the geopolitical tensions in Nigeria, winter weather conditions and unexpected changes in the US oil stocks stand out as key drivers of a sudden upward or downward shift in crude oil prices.

Graph 2.2.10. Crude Oil (Brent) and Gold Prices
(US dollar/Barrel, US dollar/Troy ons)



Source: Bloomberg.

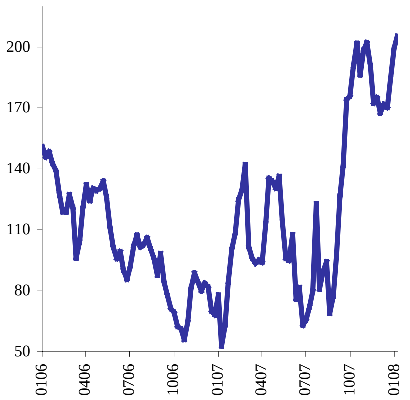
The ongoing turbulence in the developed countries' financial markets, the rising trend in their inflation rates and their clouded growth outlook as well as the recent rapid depreciation of the US dollar drove gold prices to a historic high of USD 904.1 a troy ounce on January 14, 2008 (Graph 2.2.10). On the other hand, the near-record performance in net long positions of non-commercial investors also boosted the rise in gold prices (Graph 2.2.11). Near-term gold prices will largely depend on the performance of the US dollar vis-à-vis other currencies, the severity of the sub-prime crisis, the future trend of inflation rates and changes in the global risk appetite. The recently increased share of gold in investment portfolios of insurance companies provides hedging opportunities against these risks, which, however, raises the upside risks to gold prices.

The recent sharp increase in food prices, coupled with rising energy prices, has been the main source of the upward trend in global inflation. The use of corn and wheat, which are major components of the GS Agricultural Raw Materials Index, to produce alternative energy, and drought conditions have naturally been the fundamental reasons for the spike in their prices.[2] Furthermore, the fact that China and Russia have introduced taxes on grain exports in order to ease the food inflation in their local economies, and the US has reduced the excise tax on the corn-derived ethanol are the other factors that pushed corn and wheat prices up. Supply constraints in addition to growing demand problems attract speculators and lead to a wild fluctuation in prices. In

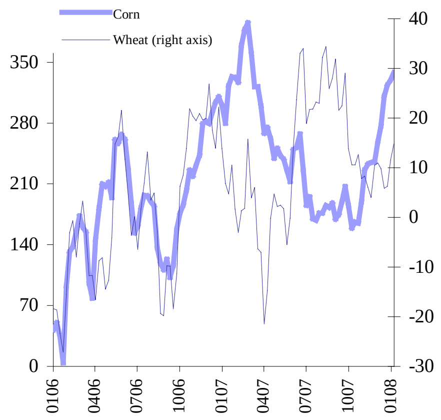
[2] CBT, Inflation Report 2007-III, Box 3.1.

this context, speculative investors' net-long positions in Chicago corn futures approached record highs. Therefore, agricultural raw material prices are expected to pose an upside risk to inflation in the upcoming period.

Graph 2.2.11. Comex Non-Commercial Investors Net-Long Positions (Gold, thousand contracts)



Graph 2.2.12. Chicago Board of Trade Non-Commercial Investors Net-Long Positions (Corn, thousand contracts)

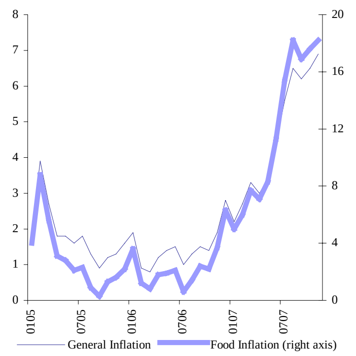


Source: Bloomberg.

BOX: A BRIEF OVERVIEW OF THE APPRECIATION OF YUAN AND ITS LIKELY RESULTS

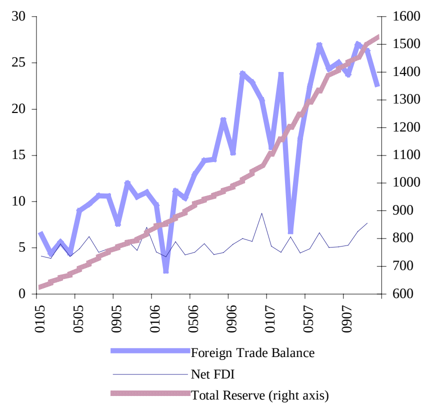
The fast-growing Chinese economy has seen a marked increase in its inflation rates since 2007. China's inflation rate surged to a 10-year high of 6.9 percent in November and is believed to rise in the upcoming period, which has prompted the People's Bank of China (PBC) to revise its monetary policy implementation. Here, we will discuss the policy change announced by the PBC in its latest monetary policy report as "use of exchange rate in coordination with other monetary policy instruments to fight against inflation" and its impacts on the world economy.

Graph 1. China General and Food Inflation Rates



Source: Bloomberg.

Graph 2. China Foreign Trade Balance, Net FDI and Reserves



Source: Bloomberg.

The most important channel which has put upward pressure on inflation in China recently is the rapidly growing money supply driven by large inflows of Foreign Direct Investments (FDI) (Graph 2) as well as short and medium-term capital inflows (Graph 3). Despite PBC's large-scale sterilization measures to maintain the US dollar peg, faster growth rate of money supply as compared to growth and enormous growth potential[1] of the Chinese economy, at first, encouraged interest in securities traded on the Shanghai Stock Exchange[2] (Graph 3), and then led the real estate market to expand dramatically. With increased wealth, consumption has increased rapidly and inflation has thus remained on an upward trend.

China's growing demand for all types of commodities, primarily for crude oil as well as for energy (Table 1) and base metals, has been the main driver of the rally in global commodity prices. Apart from the structural demand growth driven by drought and ethanol/bio-diesel production, food prices affected by China's strong demand, together with other commodities, become the main reason behind the price increases in general. The increased contribution of exports to growth as well as the upward trend of wages[3] parallel to increased prices of food and other commodities have further posed upside risks to inflation.

Table 1. Consumption Share of Crude Oil and Energy for Developed Countries and China (percentage)

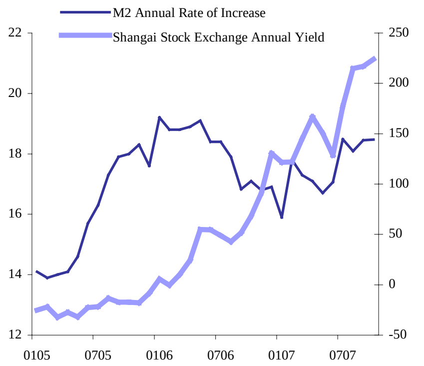
	Crude Oil				Energy*			
	USA	Japan	Europe	China	USA	Japan	Europe	China
2000	26.18	7.41	25.79	6.62	25.45	5.67	31	8.42
2002	25.72	6.99	25.54	7.02	24.38	5.42	30.09	10.61
2004	25.46	6.49	24.8	8.32	22.78	5.06	28.77	13.83
2006	24.59	6.17	24.47	8.89	21.39	4.78	27.83	15.61

* Million tons of crude oil.

[1] From 2004 through 2007 quarter 3, China has a year on year growth rate well above 10 percent and in third quarter of 2007, it has reached to 11.5 in year on year basis.
[2] On October 31, year on year growth performance of Shanghai stock exchange has reached to 224 percent.
[3] Income level of urban employees in China has increased 22 percent on yearly basis in the third quarter of 2007.

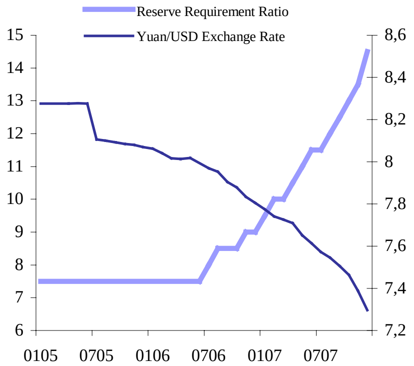
Within this framework, the PBC has adopted a tight monetary policy to curb the rising inflation, and has accordingly raised its policy interest rates and reserve requirements rapidly since mid-2006. The reserve requirement ratio reached 14.5 percent in December 2007 (Graph 4), but asset price inflation and monetary expansion could not be avoided.

Graph 3. China Money Supply (M2) Shanghai Stock Exchange Annual Percentage Change



Source: Bloomberg.

Graph 4. PBC Reserve Requirement Ratio and Yuan/USD Exchange Rate



Source: Bloomberg.

In this framework, the PBC, as declared in its third-quarter Monetary Policy Report released on November 9, 2007, besides revising its monetary policy emphasized that it could use the exchange rate actively together with other monetary policy instruments to keep inflation under control. The yuan has continued to appreciate against the US dollar, albeit at a subdued rate, since November 2007. The yuan is expected to strengthen further in the upcoming period and the exchange rate pass-through might help curb inflation. On the other hand, PBC's growing foreign exchange reserves that reached USD 1.53 trillion at end-October and the relatively low wages, as compared to international standards, cushion the Chinese economy against any shocks from the appreciation of the yuan.

The expectations of a strengthening yuan against the US dollar might affect the world economy in two ways: firstly, the trade surplus of China, gaining its competitive advantage in international trade through deliberately undervaluing its currency, will narrow. Lately, the US dollar has depreciated sharply against other major currencies. Thus, a moderate correction of global imbalances is due in the upcoming period. Secondly, the expected appreciation of the yuan against the US dollar as well as other currencies might accelerate the hot money inflow to China in the coming period.

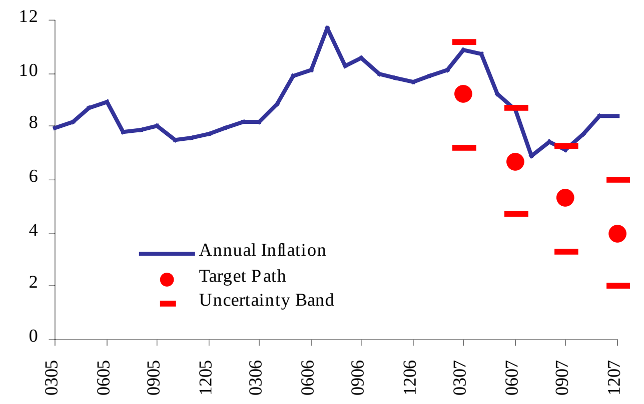
In the previous periods, the Chinese economy has been the key driver in declining global inflation rates through its undervalued currency and low labor costs, despite its demand-side pressure on commodity prices. Even though the potential strengthening of the yuan against the US dollar and other currencies in global markets will pull China's inflation rate down, it might further diminish China's ability to export deflation to the global economy through a depreciated currency and cheap labor. In other words, price increases of Chinese goods in dollar terms and in terms of other major currencies are expected to boost the upward trend in global inflation, which will eventually pose an upside risk to the inflation rate in Turkey, as in the rest of the world.

3. Inflation Developments

3.1. Inflation

Annual consumer inflation ended 2007 at 8.39 percent (Graph 3.1.1). After a steep rise in the final quarter, consumer prices fell outside the uncertainty band around the target in December, mainly due to record-high processed food and administered prices. Besides, higher energy prices boosted by strong gains in world oil prices have also put upward pressure on inflation.

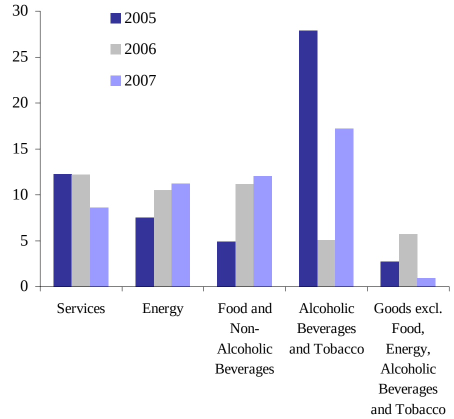
Graph 3.1.1. Target Path and CPI
(Annual Percentage Change)



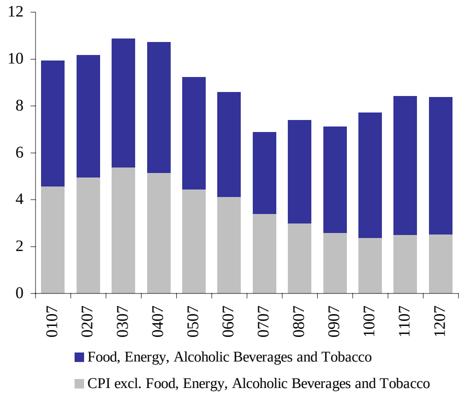
Source: TURKSTAT, CBRT.

Goods inflation remained on an upward trend during 2007, as in 2006, while services inflation moderated substantially compared with previous years (Graph 3.1.2). Higher food prices pushed inflation up in Turkey, as in the rest of the world, and both processed and unprocessed food prices increased sharply on drought-related supply issues. Energy inflation was also considerably higher in 2007 than previous years. In addition, the twice-adjusted tax on tobacco products also helped drive consumer prices higher. Accordingly, food, energy and tobacco gave an added momentum to annual CPI inflation in the second half of 2007 (Graph 3.1.3). The first-half price changes in these goods accounted for around 50 percent of the annual inflation, but the rate went up as high as 70 percent at the end of the year. Services inflation, on the other hand, was significantly lower during 2007 after remaining flat for three years (Graph 3.1.2). In sum, the spike in food, energy and tobacco prices has been the major driver of consumer inflation that lay outside the uncertainty band around the target in 2007, while other components of the CPI index have slowed down dramatically (Graph 3.1.3).

Graph 3.1.2. Consumer Prices
(Annual Percentage Change)



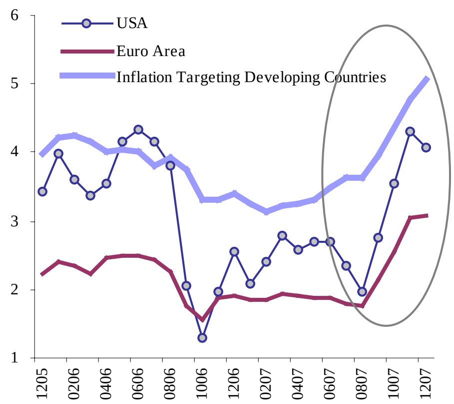
Graph 3.1.3. Food, Energy, Alcoholic Beverages and Tobacco Prices
(Contribution to Annual Inflation, Percentage Points)



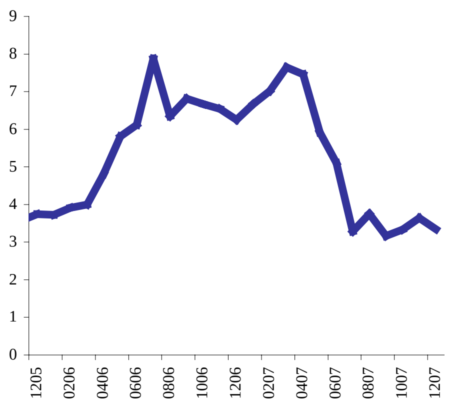
Source: TURKSTAT, CBRT.

The marked increase in oil, food and other commodity prices puts upward pressure on inflation not only in Turkey but also in the world at large. Inflation was on the rise in the US and Euro area over the last quarter, and in inflation-targeting countries during the second half of 2007 (Graph 3.1.4). Despite November's sharp rise in administered prices, Turkey's economy performed better in terms of inflation than other emerging inflation-targeting economies throughout 2007 (Graph 3.1.5).

Graph 3.1.4. Inflation Developments in Other Countries
(Annual Percentage Change)



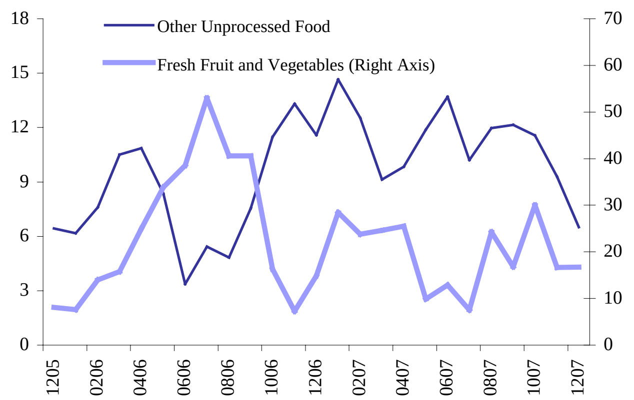
Graph 3.1.5. Difference in Inflation Rates Between Turkey and Other Inflation Targeting Developing Countries



*The Inflation Targeting Developing Countries are Brazil, Czech Republic, Israel, Colombia, Philippines, South Africa, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand.
Source: Websites of Corresponding Central Banks.

The annual rate of increase in unprocessed food prices edged down to 10.99 percent in the fourth quarter, by 2.7 percentage points from the previous quarter (Table 3.1.1). Higher prices due to supply problems over the entire year saw a partial correction in the last quarter. The 4.96 percent decline in prices of unprocessed food, other than fresh fruit and vegetables, has particularly contributed to the improved outlook for unprocessed food prices. Fresh fruit and vegetable prices, on the other hand, jumped 14.93 percent in the fourth quarter, growing at an annualized rate of 16.73 percent (Graph 3.1.6).

Graph 3.1.6. Unprocessed Food Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

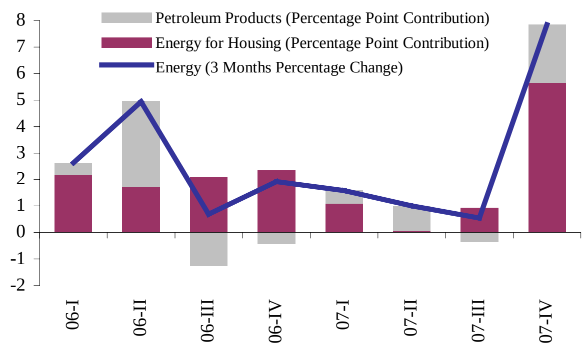
Table 3.1.1. Goods and Services Prices
(Quarterly and Annual Percentage Change)

	2006					2007				
	I	II	III	IV	Annual	I	II	III	IV	Annual
CPI	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**	**2.36**	**1.47**	**0.31**	**4.02**	**8.39**
1. Goods	**0.80**	**3.67**	**0.88**	**3.10**	**8.69**	**2.39**	**1.18**	**-0.11**	**4.65**	**8.29**
Energy	2.63	4.94	0.69	1.92	10.52	1.58	1.00	0.55	7.85	11.25
Unprocessed Food	8.81	-3.67	1.83	5.81	12.94	11.74	-5.93	2.23	3.30	10.99
Goods excl. Energy and Unprocessed Food	-2.01	5.54	0.67	2.70	6.93	-0.10	3.56	-1.01	4.09	6.60
Processed Food	1.93	0.63	4.15	2.65	9.66	2.28	0.58	4.26	5.31	12.95
Durable Goods	-1.66	8.69	1.34	-1.58	6.61	1.23	-1.73	-1.15	-1.71	-3.34
Durable Goods (excluding Gold Prices)	-3.04	5.40	2.84	-2.20	2.78	1.13	-1.36	-1.60	-2.41	-4.21
Semi-Durable Goods	-3.65	9.14	-2.14	4.75	7.81	-3.37	7.43	-3.50	7.67	7.86
Non-Durable Goods	4.64	-1.12	3.01	3.04	9.82	6.75	-2.07	2.52	4.21	11.69
2. Services	**2.41**	**3.36**	**3.83**	**2.09**	**12.21**	**2.29**	**2.28**	**1.50**	**2.32**	**8.64**
Rent	4.08	3.69	6.67	4.25	20.01	3.94	3.33	4.56	3.30	16.01
Restaurants and Hotels	3.02	4.25	3.40	2.24	13.54	2.60	1.94	2.27	3.64	10.87
Transport Services	1.27	1.36	6.26	3.50	12.89	0.10	1.70	2.10	1.91	5.93
Other Services	1.80	3.32	2.32	0.76	8.45	2.10	2.19	-0.36	1.27	5.29

Source: TURKSTAT, CBRT.

The sluggish increase in energy prices during January-September compared with previous years was outpaced by a robust 7.85 percent rise in the last quarter, changing the outlook from positive to negative (Table 3.1.1). Thus, energy prices rose by a total of 11.25 percent in annual terms. The sharp fourth-quarter increase in energy prices was due to higher water rates in November and the increased Special Consumption Tax (SCT) on fuel. World oil prices remained elevated over the entire year. Oil prices were up by around 50 percent in dollar terms at end-2007 compared to a year ago. Yet, the strengthening of the Turkish lira has cushioned the impact of soaring oil prices on the domestic economy. Although fuel prices were driven higher in the fourth quarter by skyrocketing oil prices, energy prices in general were up on the back of energy for housing items (Graph 3.1.7).

Graph 3.1.7. Energy Prices
(Quarterly Percentage Change, Percentage Point Contribution)



Source: TURKSTAT, CBRT.

After an improved second and third quarter, prices of goods excluding energy and unprocessed food increased in the fourth quarter by a record 4.09 percent from previous years (Table 3.1.1), mainly on account of the continued rise in processed food prices, SCT-driven price hikes in tobacco products and soaring gold prices. Clothing and footwear prices were up during the last quarter in line with seasonal patterns, but their outlook remained stable. Prices of consumer durables, on the other hand, continued to slow down significantly (Table 3.1.1).

Drought conditions and global economic developments continue to put serious pressure on food prices. The fourth-quarter upsurge in food inflation was mainly due to processed food prices. Prices for food production and agriculture remained elevated, and cost pressures continued to be a challenge for food prices. Accordingly, the third-quarter climb in processed food prices became more pronounced during the fourth quarter, with a dramatic 5.31 percent increase. Thus, the second-half price growth in this group amounted to

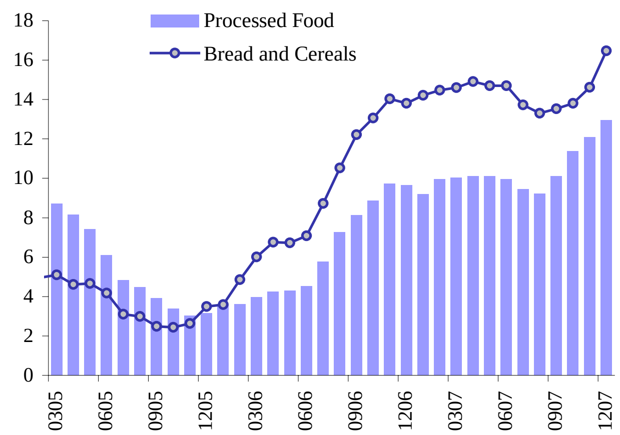
9.80 percent (Table 3.1.2), on the back of elevated prices of bread, cereals, dairy products and solid/liquid fats (Table 3.1.2, Graph 3.1.8). As production forecasts for these items point to a markedly lower outturn in 2007, supply issues become increasingly important for processed food prices. Drought-related crop losses, coupled with the use of wheat and corn to produce alternative fuels, drive world food prices higher and threaten domestic food prices. However, according to Standardized Precipitation Index (SPI) drought maps released by the State Meteorological Service, precipitation received over the last month and 3-month period was higher compared to the past twelve months. If this trend continues, unprocessed food prices will be subject to a potential correction. Yet, the reaction of processed food prices to shocks arising from crop losses is of a long-lasting nature, which suggests that processed food prices may continue to increase for some time. In sum, the fourth-quarter data indicate that risks to food prices still remain important, albeit to a lesser extent than the previous quarter.

Table 3.1.2. Processed Food Prices
(Percentage Change)

	2007 - First Half	2007 - Second Half	2007 - Overall	2007 Production Forecast* (In Comparison to 2006)
Processed Food	**2.87**	**9.80**	**12.95**	-
Bread and Cereals	5.61	10.28	16.47	Cereal production –14.4 Wheat production –13.3 Barley production –22.4
Dairy Products	1.48	16.91	18.63	-
Solid and Liquid Fat	1.10	18.78	20.09	Total oilseed production –20.1 Sunflower production –22.8

* TURKSTAT 2007 Plant Production Forecast II.
Source: TURKSTAT, CBRT.

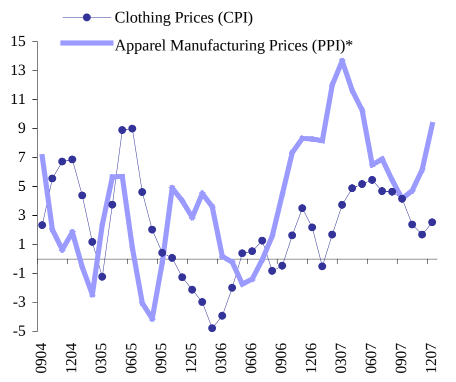
Graph 3.1.8. Processed Food and Bread - Cereals Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

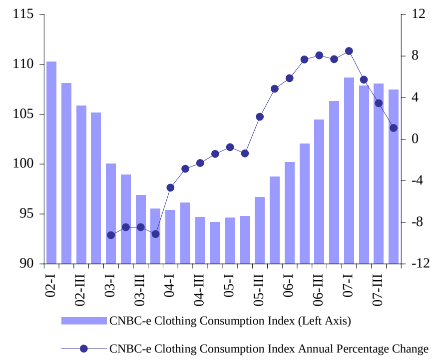
The price growth in tobacco products has been another driver for the increase in prices of goods excluding energy and unprocessed food. The group's prices rose by 6.78 percent during the last quarter following the SCT hike on tobacco products to offset part of the deterioration in the primary budget balance. Hence, tax-driven price increases in the group amounted to an annualized 17.85 percent for the entire year, adding 0.84 percentage points to annual consumer inflation. The government's tendency to raise indirect taxes as a remedy for budgetary concerns poses a risk to inflation forecasts.

Graph 3.1.9. Clothing and Apparel Manufacturing Prices
(Annual Percentage Change)



* Annual change in clothing manufacturing prices, 2 months moving average
Source: TURKSTAT.

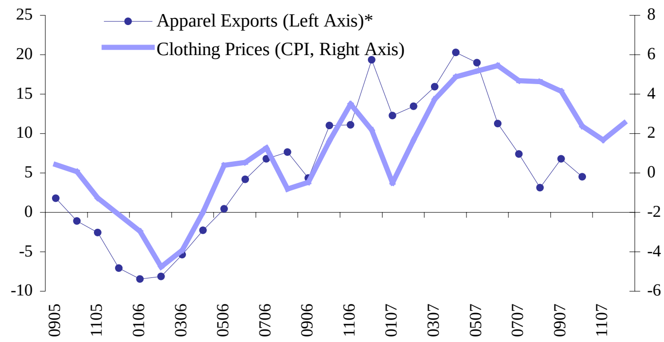
Graph 3.1.10. CNBC-e Clothing Sector Consumption Index
(Seasonally Adjusted, Three Months Average and Annual Percentage Change)



Source: CNBC-e.

After a steady climb in the first half, the annual inflation in clothing and footwear prices went down in the last two quarters to 4.08 percent at end-2007. The recent surge in apparel manufacturing prices indicates that the group suffers from strong cost pressures (Graph 3.1.9). Textile manufacturing prices, on the other hand, have followed a benign course for the last six months. Following a peak in the first quarter, the clothing component of the CNBC-e Consumption Index has registered a downward trend in seasonally adjusted terms, with less domestic sales compared to a year ago, as suggested by the annual change in the index (Graph 3.1.10). Despite the waning domestic demand for clothing, apparel exports have grown at a higher rate than last year. However, the relatively strong annual growth rate in apparel exports during the second half of 2006 and the first half of 2007 slowed down in the last quarter, and together with domestic demand conditions, helped bring the group's inflation down further (Graph 3.1.11). The impact of EU's decision to lift quotas on China's textile exports by 2008 on our local economy will be closely monitored.

Graph 3.1.11. Clothing Prices and Apparel Exports
(Annual Percentage Change)



*Three months moving average of annual rate of increase in apparel exports.
Source: TURKSTAT.

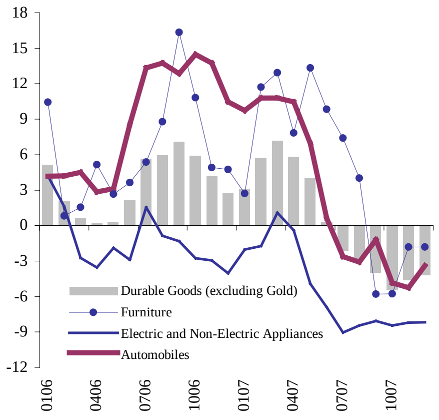
Prices of consumer durables (excluding gold) continued to fall during the fourth quarter, 4.21 percent down in 2007 from a year earlier (Table 3.1.3). Prices of electric and non-electric appliances and automobiles came down sharply. Prices of all sub-items were lower throughout 2007 compared to 2006, which is marked by a steady decline in prices of electrical and non-electrical appliances for all quarters (Table 3.1.3, Graph 3.1.12). Favorable producer prices for consumer durables, boosted by both the lagged effects of strong monetary tightening and the continued strengthening of the Turkish lira, have helped reduce the group's prices (Graph 3.1.13). Despite the third-quarter rebound in the domestic demand for consumer durables, prices continued to fall at a robust pace during the last two quarters, which suggests that the increased demand is merely a response to changes in relative prices and therefore does not put pressure on inflation. Performance indicators such as domestic sales of automobiles and furniture manufacturing have shown that the modest recovery in the demand for consumer durables continued into the fourth quarter of 2007, and current prices imply that the above outlook is preserved.

Table 3.1.3. Durable Goods Prices
(Quarterly and Annual Percentage Change)

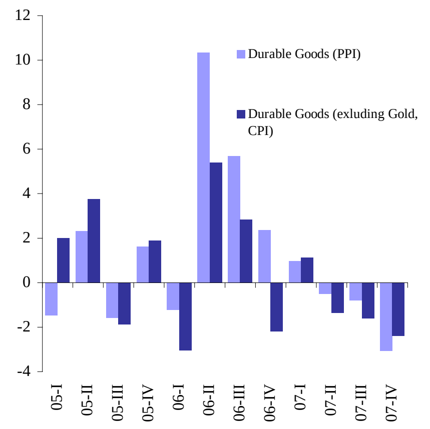
	2006				2007				
	II	III	IV	Annual	I	II	III	IV	Annual
Durable Goods(excluding Gold)	**5.40**	**2.84**	**-2.20**	**2.78**	**1.13**	**-1.36**	**-1.60**	**-2.41**	**-4.21**
Furniture	7.45	9.21	-3.17	4.74	-0.60	4.50	-6.34	0.94	-1.80
Electric and Non-Electric Appliances	4.51	-0.54	-2.25	-4.03	-0.52	-3.75	-1.80	-2.35	-8.18
Automobiles	7.09	2.57	-2.28	10.48	3.22	-2.74	0.71	-4.42	-3.37
Other Durable Goods	-1.86	1.43	0.91	-0.73	0.82	1.09	-0.52	0.32	1.71

Source: TURKSTAT, CBRT.

Graph 3.1.12. Durable Goods Prices
(Annual Percentage Change)



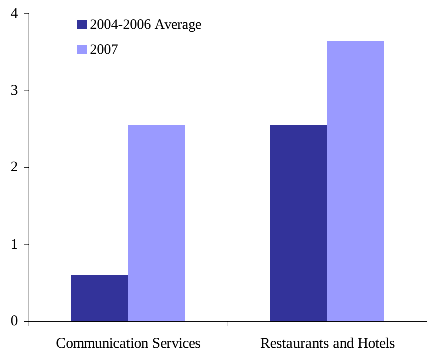
Graph 3.1.13. Durable Goods Producer and Consumer Prices
(Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

Services inflation tapered off over the entire year. Particularly during January-September, services inflation posted the lowest quarterly rate of increase since base year 2003 and fell sharply in annual terms. In the last quarter, however, services prices increased at a higher rate than previous years, pushing annual services inflation slightly up from the third quarter. This increase was mainly driven by surging prices of restaurants-hotels and communication services (Graph 3.1.14). Restaurant-hotel prices have been on the rise due to increased catering costs boosted by higher food prices. As to communication services, soaring mobile call rates curbed the downtrend in services inflation, particularly during the last quarter.

Graph 3.1.14. Communication and Restaurants-Hotels Services Prices
(Fourth Quarter Percentage Change)



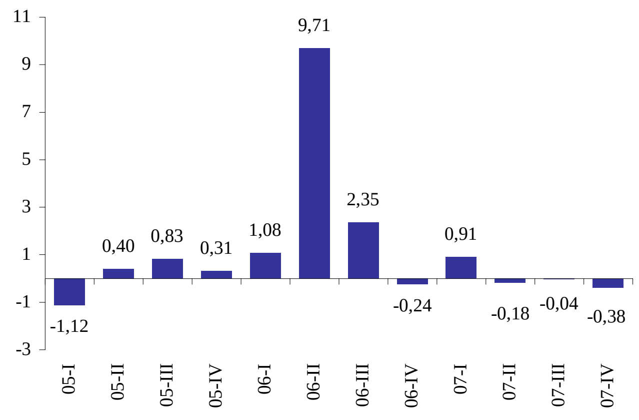
Graph 3.1.15. Services Prices
(Annual Percentage Change)

Source: TURKSTAT, CBRT.

Services inflation slowed dramatically to 8.64 percent at end-2007, by 3.6 percentage points down from 2006. The slowdown has been observed across all major sub-items, which is believed to brighten the outlook for future consumer prices (Graph 3.1.15). It is of particularly striking that the annual rental growth rate was 4 percentage points down from end-2006 after years of uppermost stickiness. Moreover, the significant decrease in the annual inflation rate for restaurants-hotels and transport services throughout 2007 has made an added contribution to the downward trend in services inflation (Graph 3.1.15).

Changes in producer prices have been of great concern as to the cost pressures on consumer inflation. Manufacturing industry prices excluding oil and food went down by 0.38 percent in the last quarter, but remained almost unchanged over the year (Graph 3.1.16). Following the cumulative strengthening of the Turkish lira, prices of capital goods and consumer durables decelerated in the fourth quarter (Table 3.1.4). Furthermore, the continued uptrend in prices of food production and agriculture point to further upward pressure on CPI food prices.

Graph 3.1.16. Manufacturing Industry Prices
(Excluding Food and Petroleum Products)
(Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

Table 3.1.4. PPI Developments According to MIGS Classification
(Quarterly and Annual Percentage Change)

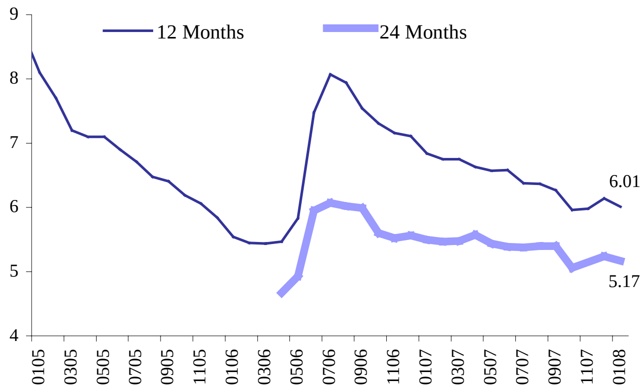
	2006					2007				
	I	II	III	IV	Annual	I	II	III	IV	Annual
Manufacturing Industry excluding Food and Petroleum	**1.08**	**9.71**	**2.35**	**-0.24**	**13.22**	**0.91**	**-0.18**	**-0.04**	**-0.38**	**0.30**
Intermediate Goods Prices	1.16	14.03	1.71	-0.54	16.69	1.29	0.58	0.15	-1.25	0.75
Capital Goods Prices	0.73	7.21	-0.03	1.86	9.96	0.03	-1.80	-0.06	-0.48	-2.32
Durable Goods Prices	-1.22	10.34	5.68	2.37	17.91	0.96	-0.51	-0.80	-3.06	-3.41
Non-Durable Goods Prices	0.93	0.62	2.72	0.82	5.18	1.54	1.10	2.40	2.88	8.15
Energy Prices	10.14	25.03	-8.91	-2.62	22.15	2.64	0.19	4.22	2.65	10.02

Source: TURKSTAT, CBRT.

3.2. Expectations

Both the 12-month and 24-month-ahead inflation expectations were on the decline for the entire year, and the fourth-quarter improvement was quite weak. This was largely due to the partial indexation of prices to past inflation, and the adjustments in administered prices. As of January, the inflation rate is expected to be 6.01 percent at a 12-month horizon and 5.17 percent at a 24-month horizon. The fact that medium-term inflation expectations exceed the target requires a prudent monetary policy (Table 3.2.1)

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



* CBRT Expectations Survey. Second survey period expectations
Source: CBRT.

The coefficient of variation[1] that measures inflation uncertainty remained quite unchanged (Table 3.2.1).

Table 3.2.1. Consumer Inflation Expectations

Current Period	Survey Period	End-Year Expectation*	12 Months Ahead		24 Months Ahead	
			Average Expectation*	Coefficient of Variation	Average Expectation*	Coefficient of Variation
January-07	1	6.98	6.84	0.08	5.43	0.14
	2	7.04	6.84	0.07	5.50	0.13
February-07	1	7.16	6.77	0.08	5.43	0.13
	2	7.13	6.75	0.07	5.47	0.13
March-07	1	7.26	6.83	0.13	5.48	0.12
	2	7.28	6.75	0.10	5.48	0.11
April-07	1	7.44	6.64	0.11	5.54	0.15
	2	7.48	6.63	0.11	5.57	0.14
May-07	1	7.78	6.63	0.14	5.52	0.15
	2	7.84	6.57	0.11	5.44	0.12
June-07	1	7.66	6.47	0.11	5.40	0.14
	2	7.67	6.58	0.13	5.39	0.12
July-07	1	7.44	6.25	0.11	5.30	0.13
	2	7.49	6.38	0.09	5.38	0.11
August-07	1	7.15	6.31	0.12	5.35	0.14
	2	7.16	6.37	0.12	5.40	0.12
September-07	1	7.13	6.27	0.12	5.44	0.13
	2	7.18	6.27	0.10	5.40	0.13
October-07	1	6.97	6.04	0.11	5.25	0.13
	2	6.94	5.96	0.12	5.06	0.11
November-07	1	7.77	5.82	0.11	5.05	0.13
	2	7.90	5.98	0.09	5.15	0.09
December-07	1	8.66	6.09	0.11	5.21	0.14
	2	8.64	6.14	0.13	5.24	0.15
January-08	1	6.44	5.94	0.11	5.11	0.14
	2	6.47	6.01	0.13	5.17	0.14

* Average expectation figures presented in the table are specified through comparing the appropriate means designated based on the comparison of arithmetic mean, median, mode, alpha and trimmed mean and extreme value analysis.
Source: CBRT.

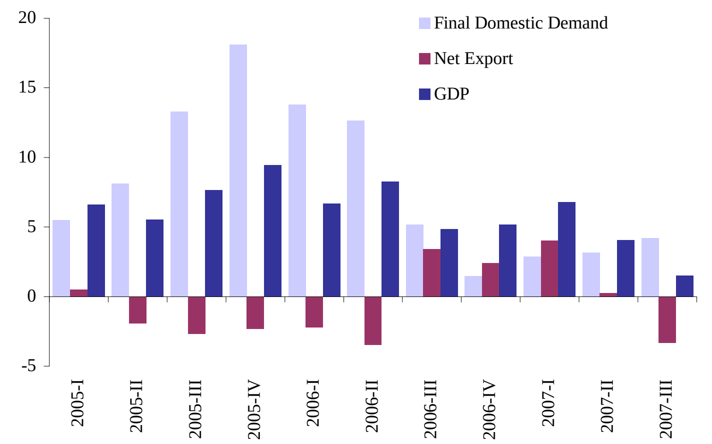
[1] The coefficient of variation, which indicates the deviation of participants' expectations, is the ratio of standard deviation to the mean in a data set with the appropriate mean.

4. Supply and Demand Developments

4.1. Supply-Demand Balance

GDP expanded by 1.5 percent in the third quarter of 2007 compared with a year earlier. During this period, the contribution of domestic demand to GDP growth increased on rebounding private consumption expenditures while that of the public sector declined, and the contribution of net foreign demand to growth changed from positive to negative (Graph 4.1.1). The government's budgetary tightening curbed investment spending, as foreseen in our October Inflation Report, while private investment's contribution to GDP growth was realized below our anticipations. The uncertainty over elections in July and the dampened global risk perceptions in August and September might have hampered investments in the third quarter.

Graph 4.1.1. Contributions to Annual GDP Growth
(Percentage Point)



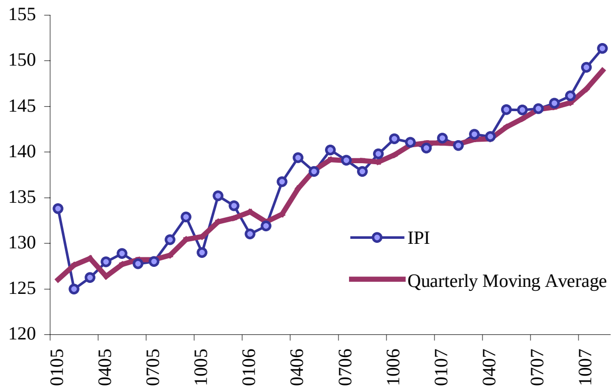
Source: TURKSTAT, CBRT.

As regards supply conditions, the value-added in agriculture that accounts for a relatively large share of national income in this quarter of the year decreased by 7.8 percent due to drought, and thereby weakened GDP growth. Besides, annual growth in the value-added of the construction sector has also lagged behind previous quarters.

In the third-quarter, GDP declined by 0.6 percent from the previous quarter in seasonally adjusted terms. Although economic activity saw an upturn in the second quarter, after a slowdown period that started in mid-2006, thanks to the temporary contribution from the public sector and the accelerated private investment demand, it followed a pattern similar to that of the past one year during the third quarter. In this period, the increased risk perception, driven by uncertainties over the general election and the financial market volatility triggered by the US sub-prime mortgage crisis, as well as supply shortfalls in agricultural products, and the lagged effects of strong monetary tightening were the major reasons behind the slowdown in economic growth.

Leading indicators for the fourth quarter signal that economic activity continues to expand at a moderate pace. Accordingly, industrial production grew at an annual rate of 8.3 and 7.7 percent in October and November, respectively, and the October-November average was well above the third quarter in seasonally adjusted terms (Graph 4.1.2). The manufacturing industry’s capacity utilization rate for December is also an evidence of continued production gains in the last quarter.

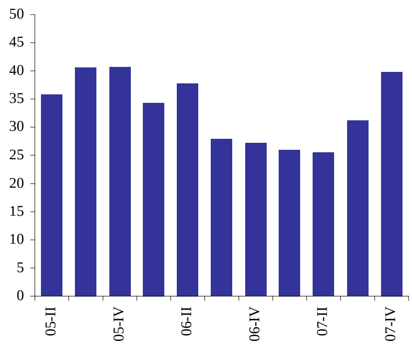
Graph 4.1.2.Industrial Production Index
(Seasonally Adjusted)



Source: TURKSTAT, CBRT.

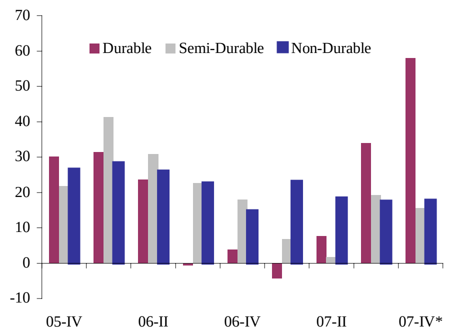
Domestic sales of automobiles, a leading indicator for consumption demand, jumped at an annual rate of 36.6 percent during the last quarter of the year, and sales were significantly over the preceding quarter in seasonally adjusted terms (Graph 4.1.3). Real consumer loans continued to grow moderately in December. Import quantity indexes for selected items of consumer goods, particularly automobiles and durables, increased annually at high rates in the last quarter (Graph 4.1.4). The seasonally adjusted fourth-quarter CNBC-e Consumption Index also continued to be on the rise. In sum, leading indicators suggest that the third-quarter rebound in private consumption demand somewhat strengthened in the fourth quarter of the year. Furthermore, it should be born in mind that automobile sales are still at the level of end-2005 despite strong gains, and the quarterly growth rate of real consumer loans, though improved substantially over previous quarters, still remains below the period in which domestic demand was more robust (Graph 4.1.5). Furniture manufacturing also followed a similar pattern (Graph 4.1.6).

Graph 4.1.3. Domestic Sales of Automobiles
(Seasonally Adjusted, Monthly Average, Thousand)



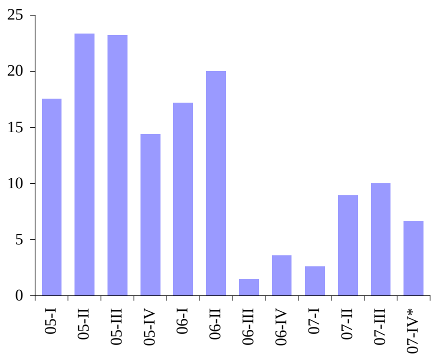
Source: AMA, CBRT.

Graph 4.1.4. Import Quantity Indexes of Consumption Goods by Items
(Annual Percentage Change)



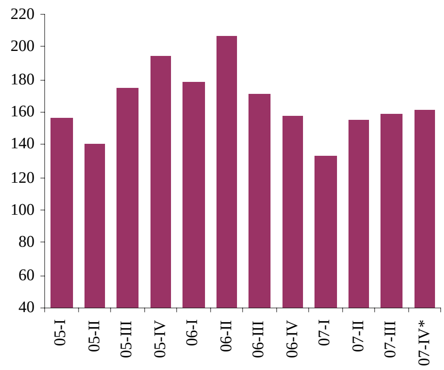
* Latest data cover the October-November period.
Source: TURKSTAT.

Graph 4.1.5. Consumer Credits
(Real, Quarterly Percentage Change)



* Includes October-November period.
Source: TURKSTAT, CBRT.

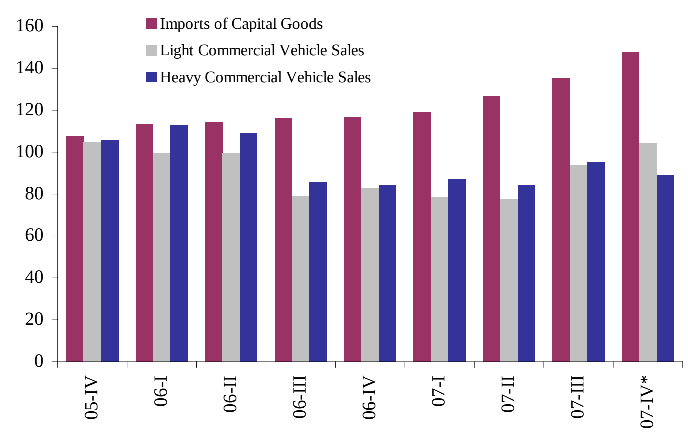
Graph 4.1.6. Production of Furniture
(Seasonally Adjusted, Monthly Average, 1997=100)



* Includes October-November period.
Source: TURKSTAT, CBRT.

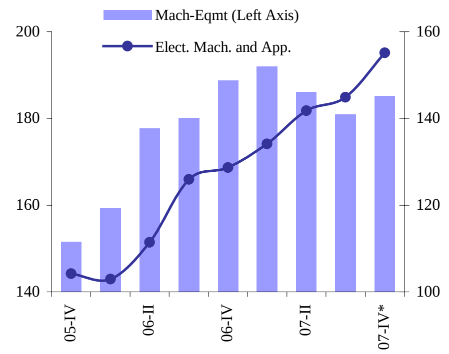
Investment demand indicators suggest that machinery-equipment investments were up both annually and quarterly in the final quarter. Imports of capital goods grew at a high rate of 36.2 percent annually during October-November, up from the third quarter in seasonally adjusted terms (Graph 4.1.7). Sales of light commercial vehicles recorded high growth rates during the third quarter, both on a quarterly and yearly basis, after a sluggish performance over the past twelve months from mid-2006 onwards and an annual downturn, driven by strong monetary tightening. Sales of these vehicles continued to be on the rebound during the last quarter, growing at a high rate over the third quarter in seasonally adjusted terms and at an annual rate of 23.6 percent. Sales of heavy commercial vehicles, on the other hand, were on a steady monthly decline starting from September and rose by only 1.6 percent annually in the fourth quarter, falling behind the previous quarter. Yet, production and import figures for machinery-equipment and electrical machinery and apparatus industries further underpinned the fourth-quarter rise in investments (Graph 4.1.8 and Graph 4.1.9).

Graph 4.1.7. Imports of Capital Goods and Domestic Sales of Commercial Vehicles
(Seasonally Adjusted, Monthly Average, 2005=100)



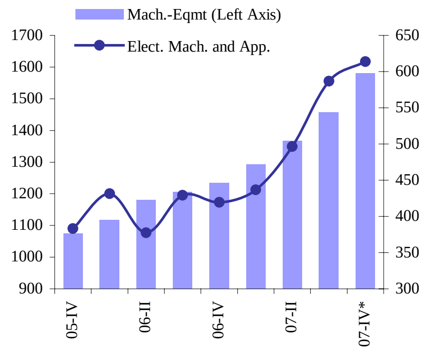
* Imports of capital goods include October-November period.
Source: TURKSTAT, AMA and CBRT.

Graph 4.1.8. Production of Machinery- Equipment and Electrical Machinery and Apparatus
(Seasonally Adjusted, Monthly Average,1997=100)



* Includes October-November period.
Source: TURKSTAT, CBRT.

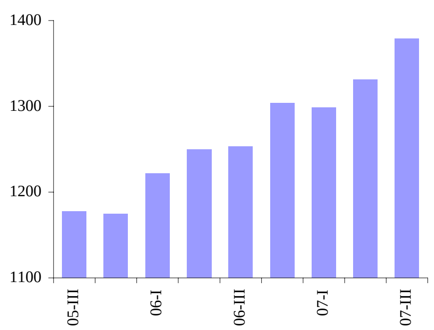
Graph 4.1.9 Import of Machinery-Equipment and Electrical Machinery and Apparatus
(Seasonally Adjusted, Monthly Average, Thousand)



* Includes October-November period.
Source: TURKSTAT, CBRT.

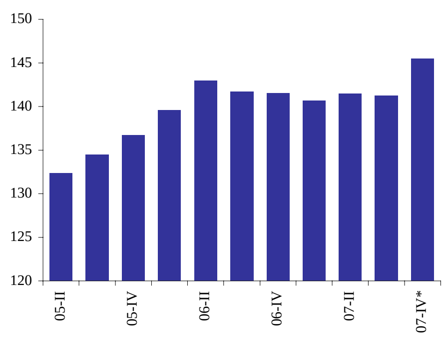
Building permits, an indicator for construction investments, were issued less in the third quarter, down 10.7 percent from a year earlier. Following the first-half decline in residential building permits, permits not only for residential buildings but also for industrial and commercial buildings were down in the third quarter on an annual basis. These indicators evidence a marked slowdown in the construction industry compared to previous quarters. However, the second and third-quarter jump in seasonally adjusted construction employment suggests that the industry will not suffer from a serious slowdown (Graph 4.1.10), which is also supported by the fourth-quarter production and import data for the non-metallic minerals industry (Graph 4.1.11). Moreover, since their value-added also covers projects that started in previous years, construction investments are expected to expand in the fourth quarter, albeit at a slower pace than previous years.

Graph 4.1.10.Employment in Construction Industry
(Seasonally Adjusted, Thousand People)



Source: TURKSTAT, CBRT.

Graph 4.1.11. Production of Non-Metallic Minerals Industry
(Seasonally Adjusted, Monthly Average, 1997=100)



* Includes October-November period.
Source: TURKSTAT, CBRT.

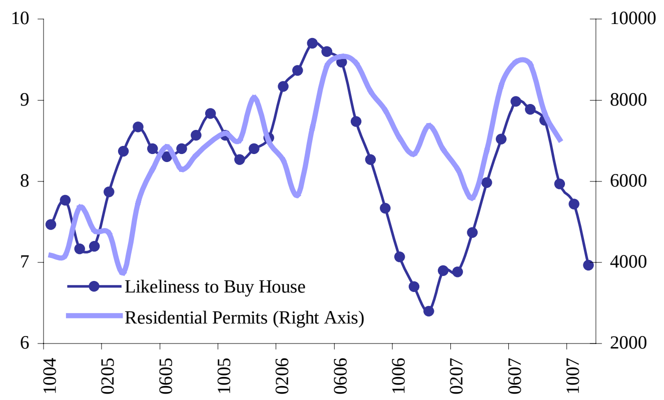
Current indicators suggest that the construction industry will not flourish in 2008. Based on the fact that the year 2005 was marked by robust domestic demand and also by brisk construction activity, the low level of current indicators compared to 2005 for the construction industry such as building permits and employment data as well as of indicators for furniture manufacturing and domestic sales of heavy commercial vehicles provides important information for the upcoming period (Table 4.1.1). The steady monthly decline in sales of heavy commercial vehicles from September onwards might be considered as a sign of downturn in construction investments over the next quarters. Similarly, the diffusion index based on the Consumer Tendency Survey data on "consumers' likeliness to buy or build a house during the next twelve months" has been on a downward track since July, which suggests that the construction industry might also be weaker in 2008 (Graph 4.1.12). The cautious stance of monetary policy as well as tightened financial conditions and increased uncertainty over global markets also support this outlook.

Table 4.1.1 Selected Indicators Related to Construction Industry

	Total Building Permits (Thousand square meter)	Construction Value Added (Thousand YTL)	Construction Industry Employment (Thousand People)	Heavy Commercial Vehicles Sales (Number)	Production of Furniture (1997=100)	Production of Non-Metallic Minerals (1997=100)
2002	36187	5346	958	17597	132	102
2003	45516	4866	965	36642	123	112
2004	67093	5092	1030	47717	119	122
2005	99432	6189	1173	52778	166	135
2006	118469	7390	1267	51752	178	141
2006-9Months	88978	5446	1239	37556	183	142
2007-9Months	88797	6072	1316	32129	149	143
Annual Percentage Change						
2003	25.8	-9.0	0.7	108.2	-6.4	10.2
2004	47.4	4.6	6.7	30.2	-3.7	9.1
2005	48.2	21.5	13.9	10.6	40.3	10.2
2006	19.1	19.4	8.0	-1.9	6.8	4.3
2007*	-0.2	11.5	6.2	-14.5	-18.7	0.3

* First nine months.
Source: TURKSTAT, AMA.

Graph 4.1.12.Consumers' Likeliness to Buy or Build a House During the Next 12 Months (Diffusion Index) and Building Permits (Thousand square meter)
(Quarterly Moving Average)

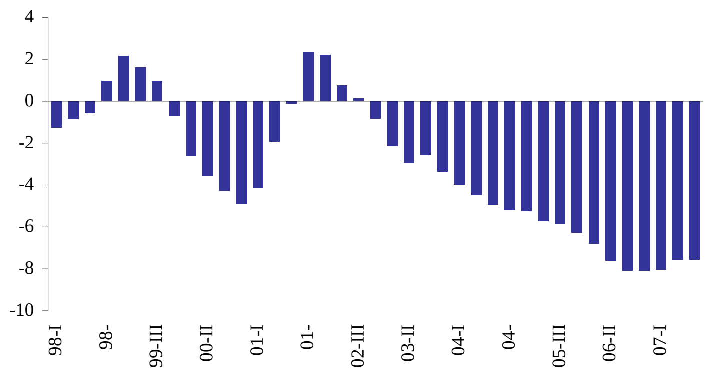


Source: TURKSTAT, CBRT.

4.2. Foreign Demand

Exports expanded at a robust rate throughout 2007 thanks to the strong performance in motor vehicles and iron/steel sectors and the increased contribution from textile and clothing sectors. The bounce-back in domestic demand and the strong Turkish lira helped imports of capital and consumption goods regain momentum in the second half of 2007. Imports of intermediate goods continued to grow at a steady pace on the back of increased industrial production boosted by a strong export performance. The second-half run-up in oil prices above the 2006-level was another key driver of import growth. Real import growth has been much stronger than that for exports since June, and the contribution of net foreign demand to GDP growth became thus negative. The current account deficit over Gross National Product (GNP) ratio dropped to 7.6 percent in the third quarter of 2007, from a peak of 8.1 percent at end-2006, as domestic demand weakened despite stronger Turkish lira and the terms of trade shifted in favor of exports (Graph 4.2.1).

Graph 4.2.1. Current Account Balance / GNP
(Annualized, Percent)

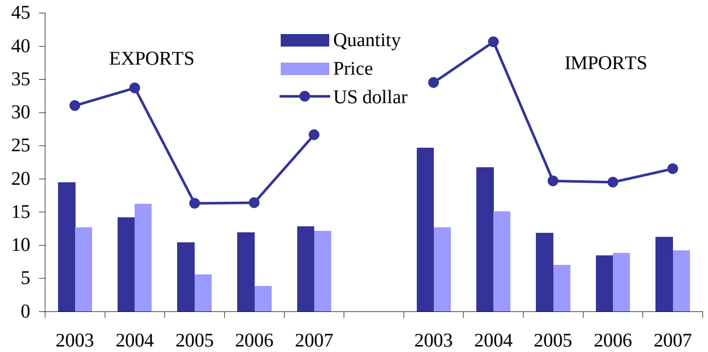


Source: CBRT.

Import growth during the July-November period accelerated on increased imports of intermediate goods driven by oil prices, as well as on imports of capital and consumption goods. The current account deficit began to widen again however, although tourism revenues retraced their earlier run-up in 2007 after a sluggish 2006 and exports continued to perform well.

Almost half of gains in nominal exports and imports in 2007 can be attributed to price hikes (Graph 4.2.2). Industries that raised their export prices were mainly base metals, motor vehicles, machinery-equipment and textiles/clothing, while import price hikes were largely boosted by industries such as base metals, chemicals and chemical products, motor vehicles and recycling.

Graph 4.2.2. Exports and Imports Growth Rates*
(Annual Percentage Change)



*January-November period for 2007.
Source: TURKSTAT.

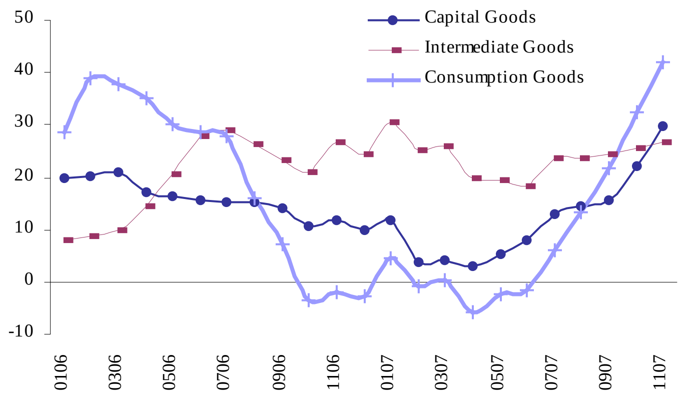
Exports grew, nominally, by 26.6 percent during the January-November period of 2007 compared to the same period of 2006. Main drivers of export growth were motor vehicles, base metals, machinery-equipment, textiles and clothing, with an added contribution from electrical machinery and apparatus and refined petroleum products.

Since over half of exports are done in euros, the recent strengthening of the euro against the US dollar has helped exports grow in dollar terms. The low growth rates of exports in particularly the first four months of 2006 paved the way for a steep rise in the same period of 2007. The export data released by the Turkish Exporters’ Assembly (TEA) suggest that exports continued to grow in December.

The negative developments associated with the US sub-prime mortgage market and a likely US recession have a potential to reduce foreign demand in 2008. However, with continued productivity and export price gains in export industries, exports are expected to continue to grow, though at a slower pace.

During the January-November 2007 period, imports grew, nominally, at 21.5 percent compared to the same period of 2006. Although the main source of growth was the imports of intermediate goods, imports of capital and consumption goods held a substantially increased share in total import growth during the second half. Imports of capital and consumption goods grew as high as 23.7 and 32.8 percent, respectively, between July and November, up from 6.4 and –0.8 percent, respectively, in the first half (Graph 4.2.3). Despite the first-half upturn, oil prices were still lower compared to a year earlier, which helped imports grow at lower rates; but starting from mid-2007, oil prices have outstripped their 2006 growth and pushed imports of intermediate goods higher. Major factors that boosted imports of intermediate goods were the mild growth in the economy, the strengthening of the Turkish lira and soaring oil prices.

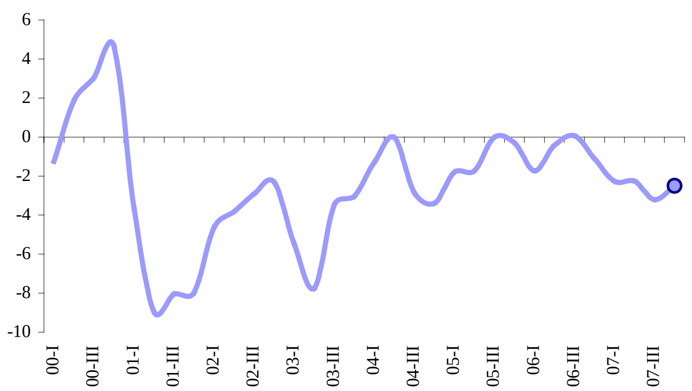
Graph 4.2.3. Sub-Items of Imports
(Annual Grorwth Rate of 3-months Moving Averages)



Source: TURKSTAT.

To sum up, indicators for the last quarter reported a continued revival in the economic activity. Moreover, the reduced share of agriculture in the fourth quarter will lower the impact of an agricultural supply shock on overall growth. The current outlook suggests a moderate growth rather than an economic overheating. In this context, private investment and consumption demand is on the rebound, whereas foreign demand contributes less to GDP growth and aggregate demand conditions continue to support disinflation (Graph 4.2.4).

Graph 4.2.4. Output Gap
(Percent)



Source: CBRT.

The above outlook is expected to be maintained in 2008 based on the following reasons: indicators for demand conditions suggest that the economy grows stronger in the last quarter than in previous quarters, but still lags behind the period in which domestic demand was more robust. The cautious stance of monetary policy, the run-up in long-term real interest rates and the upward shift in yield curves due to an increased risk perception curb domestic demand. The increased uncertainty over the extent to which global financial developments will affect global economy might be considered to pose a downside risk to export performance and, thus, to growth in 2008, which is also reflected in leading indicators for the last quarter that signal a slowdown in developed economies. Against this background, the supply/demand balance will also serve to promote further disinflation in 2008.

4.3. Unit Labor Costs

According to the index of "Production Workers, Hours Worked in Production in Manufacturing Industry" released by the Turkish Statistical Institute (TURKSTAT), employment in the manufacturing industry rose by 1.9 percent in the third quarter of 2007 over a year earlier (Table 4.3.1). Labor productivity in the manufacturing industry remained low due to the decline in production and employment. Real wages posted a very strong gain both in the public and private sector. The third-quarter growth in real manufacturing industry wages outpaced productivity gains, resulting in an upsurge in real unit wages (Graph 4.3.1). The rise in real unit wages of the manufacturing industry is quite striking in that they had hitherto helped lower inflation and boost exports further. Yet, it is forecast that, with slowing employment growth and re-accelerating productivity gains, real unit wages might go down in the fourth quarter.

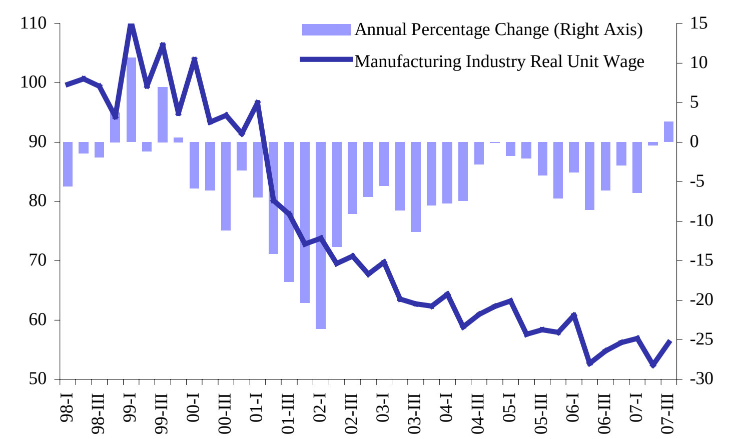
Table 4.3.1. Employment, Real Wage and Productivity Developments in the Manufacturing Industry
(Percentage Change Compared to the Same Period of the Previous Year)

	2005	2006					2007		
	Annual	I	II	III	IV	Annual	I	II	III
Employment*	-0.7	-1.9	-1.4	-0.7	1.2	-0.7	2.3	2.0	1.9
Public	-8.1	-3.3	-3.8	-5.7	-2.9	-4.1	-3.2	-3.8	0.6
Private	0.1	-1.9	-1.2	-0.2	1.6	-0.4	2.6	2.4	2.0
Wage**	2.0	1.0	0.5	0.0	2.1	0.9	-2.2	-0.5	3.7
Public	8.0	-3.9	-2.7	-4.0	-1.5	-3.0	0.3	-2.1	4.0
Private	1.7	1.9	1.3	1.2	3.1	1.9	-2.0	0.1	3.7
Earnings***	1.8	0.3	0.4	0.0	2.8	0.9	-1.2	-0.1	3.8
Public	6.1	-3.3	-2.4	-0.4	0.0	-1.5	1.1	0.3	3.1
Private	1.9	1.3	1.2	0.7	4.0	1.8	-1.0	0.5	4.0
Productivity****	6.0	5.0	9.9	6.5	5.2	6.7	4.5	-0.1	1.1

* Manufacturing Industry Employment Index, 1997=100.
** The Index of Real Wage per Working Hour, 1997=100.
*** The Index of Real Earning Per Worker, 1997=100.
**** The Index of Partial Productivity Per Working Hour, 1997=100.
Source: TURKSTAT, CBRT.

Possible future increases in real unit wages remain a risk to the inflation outlook. In order for real unit wages to promote further disinflation, measures are to be taken in the medium term to ensure further productivity gains and improve the investment climate, as highlighted in our October Inflation Report. Moreover, it is still of great importance that wages are set in accordance with the inflation target, so that their contribution to the disinflation process continues.

Graph 4.3.1 Real Unit Wages Index in the Manufacturing Industry
(1997=100)



Source: TURKSTAT, CBRT.

5. Financial Markets and Financial Intermediation

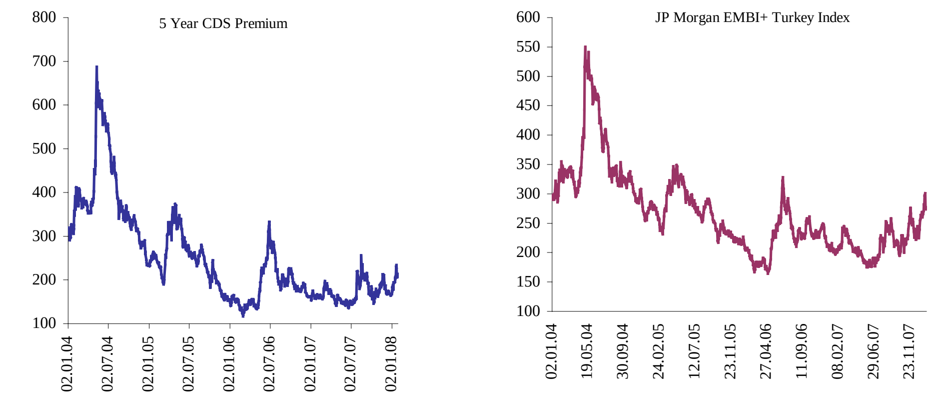
5.1. Financial Markets

The deterioration in risk perceptions due to developments in credit markets and the resulting liquidity squeeze in developed financial markets continued in the fourth quarter of 2007. Losses stemming from the sub-prime mortgage meltdown were higher than expected during this period.

In the third quarter of 2007, central banks of the developed world provided larger liquidity facilities for troubled markets and loosened monetary policy stance in an effort to rebuild confidence in financial markets. However, the recently released data show that the credit market and banking turmoil spilled over into the wider US economy, which ultimately led to a resumed deterioration in global risk appetite and emerging-market risk premiums (Graph 2.2.1, Graph 2.2.2 and Graph 2.2.3).

The downturn in developed financial markets and worries over the global growth outlook caused emerging markets to fluctuate by means of tight global liquidity conditions and risk aversion. As matter of fact, Credit Default Swap (CDS) and JP Morgan EMBI+ Turkey indices began an upward trend (Graph 5.1.1). Given the uncertainties over global economic prospects, international financial markets are expected to remain sensitive to future growth rates and financial fragility in developed economies.

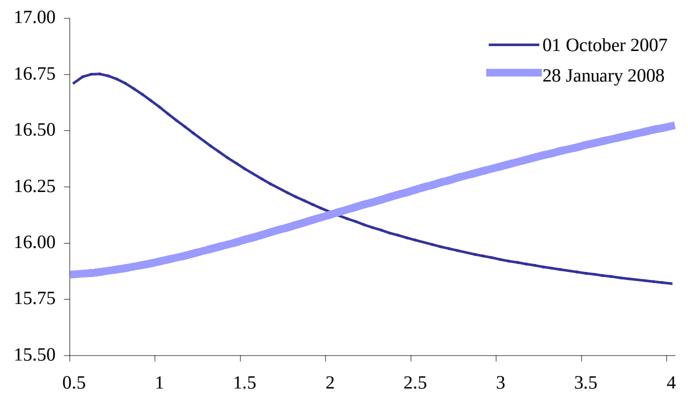
Graph 5.1.1. Risk Premium Indicators



Source: Bloomberg.

Due to CBRT policy rate cuts and lowered medium-term inflation expectations, yields on maturities up to two years on January 28, 2008 fell below those on October 1, 2007. The reductions in policy rates since September put downward pressure on the short- and medium-term horizons of the yield curve, whereas increasing term premiums, boosted by heightened uncertainty about global financial markets, and less-aggressive CBRT policy rate cuts drove long-term yields higher (Graph 5.1.2).

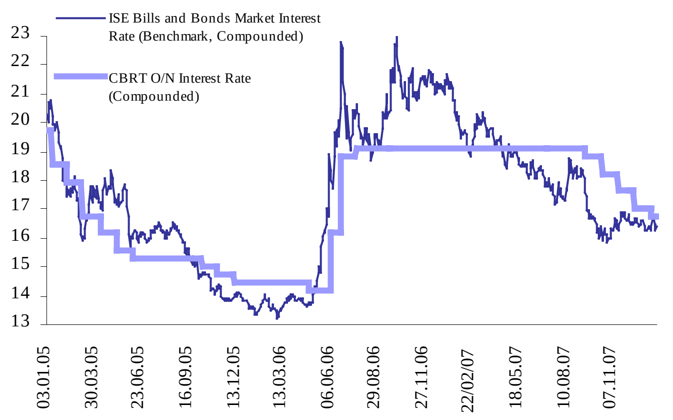
Graph 5.1.2. Yield Curves
(Percent)



Source: CBRT.

The steady decline, experienced since early 2007, in the interest rate on the benchmark government security in the Istanbul Stock Exchange (ISE) Bonds and Bills Market was suspended in the fourth quarter. During this period, the gap between CBRT policy rate and benchmark security rate narrowed thanks to CBRT's measured rate cut policy (Graph 5.1.3).

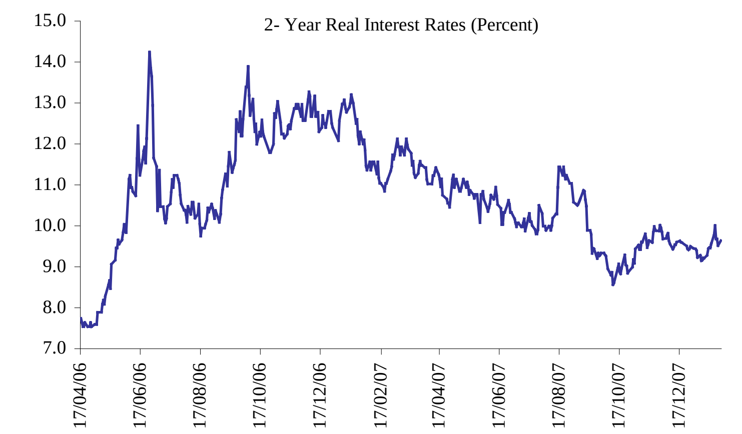
Graph 5.1.3. Interest Rate Developments
(Percent)



Source: ISE, CBRT.

Real interest rate derived using the nominal yield values read from the yield curve for a 2 year maturity and 12 and 24 month inflation expectations drawn from CBRT's Expectations Survey continued to trend downward in the fourth quarter (Graph 5.1.4). Yet, 2-year real interest rates have recently ranged between 9 and 10 percent and thus contributed to lower inflation.

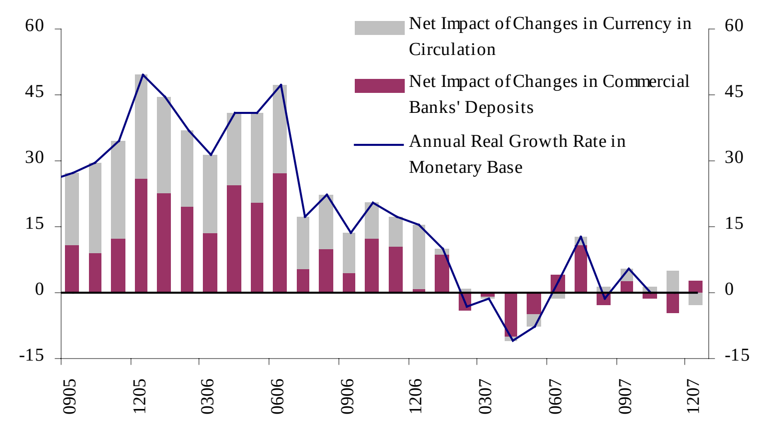
Graph 5.1.4. Real Interest Rates
(According to the Yield Curve and 12 and 24- Month Inflation Expectations)



Source: ISE, CBRT.

In sum, CBRT's current monetary policy stance continues to support disinflation, despite rate cuts since September. The fourth-quarter annual growth rate of the monetary base also serve to bolster this outlook (Graph 5.1.5).

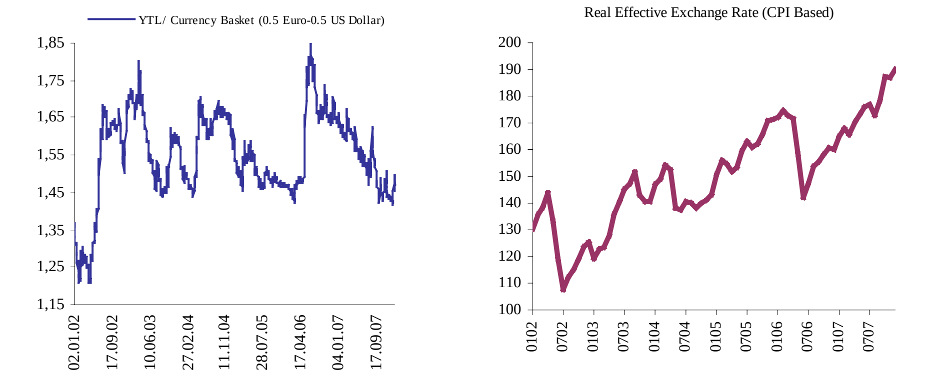
Graph 5.1.5. Annual Real Growth Rate in Monetary Base
(Percent)



Source: CBRT.

During the fourth quarter, concerns about the US economy and Fed policy rate reductions have pushed down the value of the US dollar against other major currencies. In this sense, the continued appreciation of the new Turkish lira contributed to lower inflation further (Graph 5.1.6).

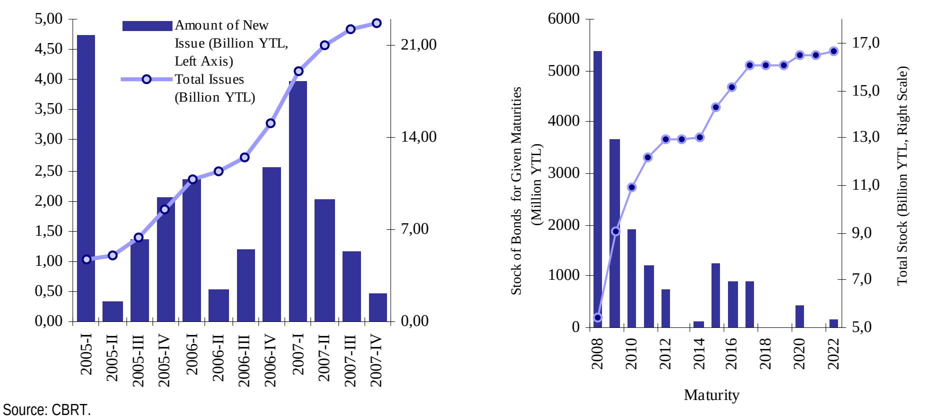
Graph 5.1.6. Developments in Exchange Rates



Source: CBRT.

The global liquidity crisis and the reduced international risk appetite tightened financing conditions. In fact, the amount of YTL-denominated global bonds issued by foreign financial institutions, an indicator of foreign demand for YTL-denominated assets, decreased substantially in the fourth quarter from the previous quarter and from the same quarter of previous years (Graph 5.1.7).

Graph 5.1.7. YTL Denominated Bonds Issued by Foreign Financial Institutions

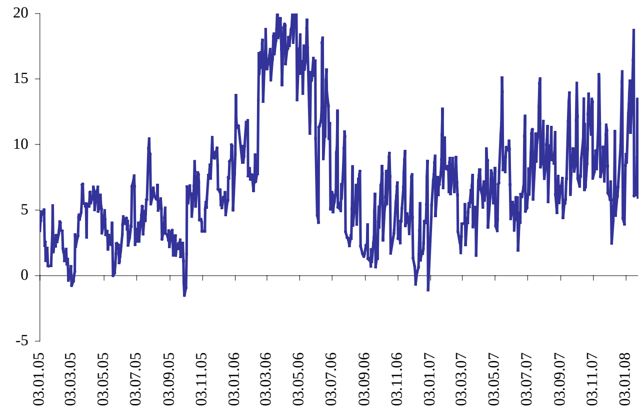


Source: CBRT.

CBRT’s net foreign exchange purchase through several auctions amounted to 3.25 billion US dollars in the fourth quarter of 2007. CBRT’s foreign exchange reserves rose to 72 billion US dollars as of January 18.

Excess liquidity sterilized through the overnight market increased in the fourth quarter over the previous one (Graph 5.1.8). Moreover, in order to enhance the effectiveness of liquidity management, the CBRT issued 61-day liquidity bills on November 16. Excess liquidity is expected to persist in the upcoming period, along with Treasury's roll-over rate set below the year-ago level and CBRT's scheduled foreign exchange purchases.

Graph 5.1.8. Excess YTL Liquidity
(Billion YTL)

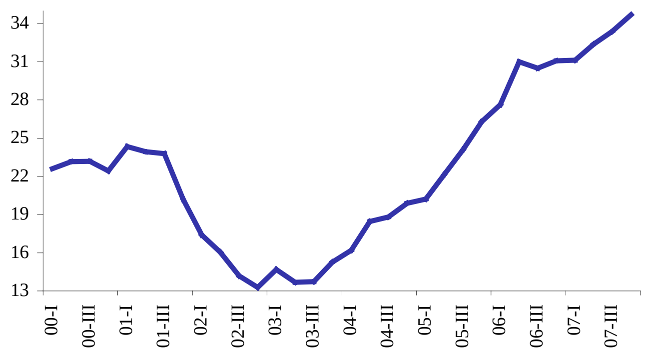


Source: CBRT.

5.2. Financial Intermediation and Loans

The moderate credit growth continued into the fourth quarter. Real sector loans continued to grow, expanding their ratio to the national income further (Graph 5.2.1).

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



*Real sector loans are composed of consumer loans and business loans. GNP of 2007-IV shows estimated figures.
Source: CBRT.

Though continued into the fourth quarter of 2007, the growth of consumer loans was slightly slower than the previous quarter partly due to reduced financial resources resulting from the global financial turmoil. Consumer loans, as in previous quarters, grew largely on the back of "other loans" consisting of personal loans. Housing loans and use of credit cards continued to grow albeit at a slower rate. Despite a rebound inspired by ad-campaigns of banks, automobile loans decreased in real terms (Table 5.2.1).

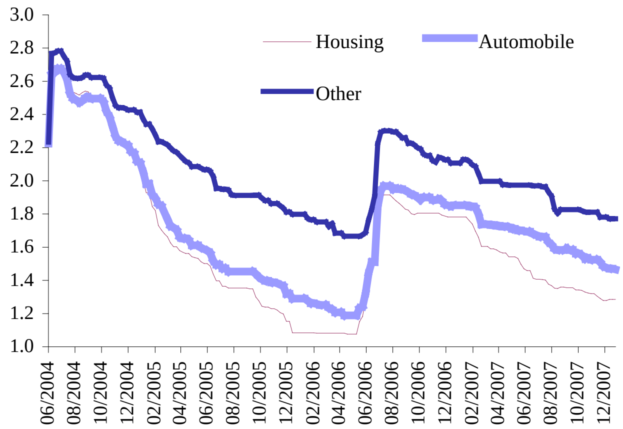
Table 5.2.1. Consumer Loans and Claims from Credit Cards
(Real Quarterly Percentage Change)

	2006		2007			
	III	IV	I	II	III	IV
Consumer Loans	1.5	3.6	2.6	9.0	10.0	6.6
Housing Loans	0.9	2.2	2.7	7.5	10.2	5.4
Automobile Loans	-6.4	-5.0	-8.9	-3.4	-2.0	-1.4
Other Loans	6.0	8.9	6.6	14.5	12.8	9.9
Credit Cards	2.1	2.1	-1.6	7.7	2.4	3.2

Source: CBRT.

The downtrend in interest rates on consumer loans decelerated in the fourth quarter (Graph 5.2.2). Banks turned cautious in the final quarter in spite of policy rate reductions and left their interest rates on loans almost unchanged. The increased competition among banks and the reduced inflation rate are expected to reduce interest rates further in the medium and long run.

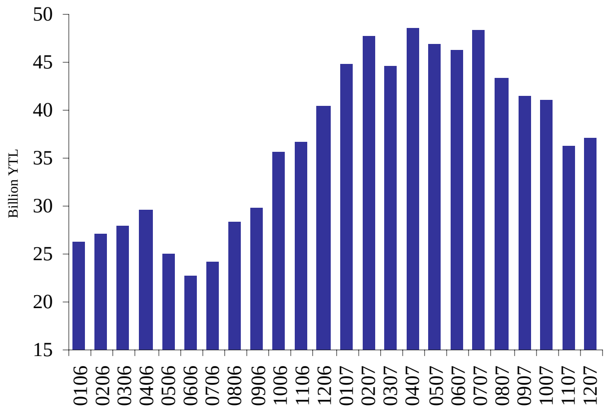
Graph 5.2.2. Consumer Loan Rates
(Monthly, Percent)



Source: Web sites of selected banks.

The fact that interest rates on medium- and long-term bank loans are still higher than they were in the first quarter of 2006, although they have been on the decline since early 2007, curbed the demand for loans. The reduced ability of commercial banks to provide loans due to the waning global risk appetite restrains their credit supply. In fact, the suspended issuance of YTL-denominated bonds by foreign financial institutions (Graph 5.1.7) suggests that commercial banks may have less access to YTL denominated loans abroad. Moreover, the falling amount of government securities held by non-resident investors might limit financial markets' credit supply (Graph 5.2.3). The more pronounced global financial breakdown hinders the accessibility of commercial banks to foreign sources of finance. Yet, expectations over a further reduction in Treasury's roll-over rate and future auctions for purchasing foreign exchange might fuel liquidity and credit growth.

Graph 5.2.3. Government Securities Held by Non-Residents
(Nominal)



Source: BRSA.

In sum, both the increased perception of uncertainty and the reduced credit supply will moderate credit expansion in the upcoming period. CBRT will continue to carefully monitor credit developments as they relate to the total final domestic demand and the soundness of the financial system.

6. Public Finance

The efforts to retain the very high, program-defined primary surplus target during the previous quarters and the budget reforms have helped improve public finance substantially. Thanks to these policies, the maturity of the debt stock has lengthened, debt sensitivity to exchange rates has eased and the proportional level of debt has significantly declined, therefore lowering the risk premium. The waning fiscal dominance helped enhance the effectiveness of monetary policy. Thus, perceptions of uncertainty about future prospects faded and predictability increased, which ultimately improved the outlook for both inflation and overall economic growth and brought inflation down to single-digit levels. In addition to macro-level fiscal policies, fine-tuning measures should also be implemented efficiently to help fiscal policy remain supportive of the disinflation process in the next period, and thus to fully maintain price stability.

With the high level of unregistered economic activity in Turkey and the gradual increase in the share of special consumption taxes on goods, the share of direct taxes in total tax revenues declined, and therefore the major driver of the primary budget surplus for the past few years has been indirect taxes. As to budget expenditures, some primary expenditure items were kept under control, but total spending exceeded projected targets mainly due to structural issues such as social security and health care. The brisk domestic demand before and during 2006 boosted indirect tax revenues, which brought primary surplus to the target level despite the deviation of several expenditure items from targets. However, since indirect tax revenues failed to match the target due to slackening domestic demand in 2007, and reforms to resolve structural issues were not adopted, non-interest expenditures increased higher than the targeted level, resulting in a major deviation from the program-defined primary surplus target.

Despite a wide range of recent reforms to enhance the effectiveness of fiscal policy and to strengthen the institutional structure, fiscal policy contributed little to maintaining price stability in 2007 because measures to reduce the sensitivity of tax revenues to changes in domestic demand and to trim expenditures that arise from structural problems had not been effectively implemented. In order to offset the indirect tax loss in 2007, the government increased the taxes on tobacco and oil products in November. Nevertheless, this offsetting measure resulted in the acceleration of inflation. Taking into account that the impact of previous adjustments in indirect taxes on the inflation rate was asymmetrical; that is, indirect tax rises were immediately reflected on consumer prices while reductions generally failed to yield the same result, it is necessary to emphasize that changes in indirect taxes are important for inflation expectations and the inflation target.

In order to maintain price stability under an inflation targeting regime, monetary and fiscal policy should be coordinated both on a macro and micro level (such as tax adjustments). In this context, micro reforms to create fiscal space and to improve public finance should be implemented without delay, and fiscal policy regulations, particularly tax adjustments, should be aligned with the objective of monetary policy. The primary focus of fiscal policy, which plays a key role in avoiding macroeconomic instability in Turkey, should be shifted towards micro-level imbalances in the coming period in order to ensure the continuity and permanence of gains from the program implemented.

Within this framework, it is of prime importance that the government struggles against unregistered economy in an attempt to both alter budget dynamics (creating fiscal space) and enhance the economy, and promptly implements the structural reforms that aim to improve the social security system, the labor market and the competitive environment in the economy.

6.1. Budget Developments

In 2007, the central government primary balance posted a surplus of YTL 34.9 billion, while the budget balance ran a deficit of YTL 13.9 billion (Table 6.1). According to a detailed analysis of the central government budget, revenues and expenditures were up by 9.3 and 14.3 percent, respectively, compared with 2006. The budget performance deteriorated in 2007 compared to 2006, but met the target for the central government budget balance.

Non-tax revenues rose by only 1.1 percent, whereas tax revenues grew by 11.2 percent for the entire year. Moreover, revenues from direct taxes (sum of taxes on wages and profits and taxes on property) increased by 19.8 percent over 2006, while revenues from indirect taxes (sum of taxes on domestic goods and services and taxes on international trade and transactions) increased by a mere 6.4 percent. 2007 proved to be a year that domestic demand weakened and therefore consumption-related taxes performed poorly. Direct taxes, on the other hand, performed well above the target on the back of strong corporate tax revenues boosted by the increased profitability of the financial sector.

In 2007, interest expenditures and primary budget expenditures rose by 6.0 and 17.1 percent, respectively, over 2006. As regards non-interest expenditure items, goods and services expenditures plus resources allocated for social security have significantly exceeded the initial appropriation amount for 2007. Other expenditures items were on track to meet year-end targets.

Under the assumption that the social security reform would have been implemented in 2007, the appropriations for treatment and medication services provided for public employees and green-card holders were transferred from the health care item classified under goods and services into the budget of the Social Security Institution. Yet, since the reform failed to materialize, health care expenditures remained an item of goods and services and substantially exceeded the initial appropriation.

Table 6.1.1. Central Government Budget Aggregates (Billion YTL)

	2006	2007	Rate of Increase (Percent)	Realization/ Budget Target (Percent)	2007 Budget Target	2007 Budget Target/GNP*
Central Government Expenditures	**178.13**	**203.50**	**14.25**	**99.27**	**205.0**	**32.5**
A) Interest Expenditures	**45.96**	**48.73**	**6.02**	**92.04**	**52.9**	**8.4**
B) Non-Interest Budget Expenditures	**132.16**	**154.77**	**17.10**	**101.79**	**152.0**	**24.1**
I. Personnel Expenditures	37.81	43.55	15.19	99.74	43.7	6.9
II. Government Premiums to Social Security Agencies	5.08	5.80	14.30	57.42	10.1	1.6
III. Purchases of Goods and Services	19.00	22.15	16.59	142.13	15.6	2.5
1) Defense-Security	7.63	7.58	-0.71	92.78	8.2	1.3
2) Health Expenditures	5.35	6.62	23.80	-	0.2	0.0
a) General Medication	0.81	0.97	21.08	-	0.1	0.0
b) General Treatment and Health Equipment	1.63	1.74	6.16	-	0.1	0.0
c) Green Card Health Services	2.91	3.91	34.46	-	0.0	0.0
3) Other Purchases of Goods and Services	5.94	7.89	33.02	110.54	7.1	1.1
IV. Current Transfers	49.85	63.25	26.88	103.92	60.9	9.6
1) Duty Loss	7.25	1.40	-80.66	117.97	1.2	0.2
2) Government Subventions	21.76	36.27	66.70	105.02	34.5	5.5
a) Financing of Social Security Deficit	18.54	25.82	39.26	202.09	12.8	2.0
3) Subsidies to Households	0.80	0.99	24.77	106.97	0.9	0.1
4) Agricultural Subsidies	4.75	5.56	17.03	105.81	5.3	0.8
5) Shares from Revenues	14.12	17.16	21.48	101.18	17.0	2.7
V. Capital Expenditures	12.10	12.92	6.76	106.70	12.1	1.9
VI. Capital Transfers	2.64	3.54	34.34	97.13	3.6	0.6
VII. Lending	5.69	3.55	-37.56	96.14	3.7	0.6
VIII. Reserve Appropriations	0.00	0.00	-	0.00	2.4	0.4
Central Government Revenues	**173.48**	**189.62**	**9.30**	**100.78**	**188.2**	**29.8**
A) General Budget Revenues	**168.55**	**184.24**	**9.31**	**100.42**	**183.5**	**29.1**
I-Tax Revenues	137.48	152.83	11.17	96.64	158.2	25.1
1. Taxes on Income, Profits and Gains	40.14	48.20	20.07	106.30	45.3	7.2
a) Income Tax	28.98	34.45	18.85	103.08	33.4	5.3
b) Corporate Tax	11.16	13.75	23.24	115.31	11.9	1.9
2. Taxes on Property	3.12	3.65	16.95	100.16	3.6	0.6
3. Domestic Taxes on Goods and Services	59.41	63.59	7.04	92.39	68.8	10.9
a) Domestic Value Added Tax	15.91	16.79	5.54	83.13	20.2	3.2
b) Special Consumption Tax	36.93	39.11	5.92	95.23	41.1	6.5
4. Taxes on International Trade and Transactions	27.56	28.97	5.11	90.38	32.1	5.1
a) VAT on Imports	25.43	26.49	4.20	89.55	29.6	4.7
II-Non-Tax Revenues	31.07	31.40	1.09	120.37	26.1	4.7
1. Enterprise and Property Revenue	7.53	7.90	4.95	101.10	7.8	1.8
2. Interests, Shares and Penalties	19.44	15.62	-19.64	102.60	15.2	2.4
3. Special Revenues, Grants and Aids	2.25	1.80	-20.12	375.18	0.5	0.1
4. Capital Revenues	1.84	6.08	230.07	236.84	2.6	0.4
B) Revenues of Special Budget Administrations	**3.53**	**3.80**	**7.52**	**116.29**	**3.3**	**0.5**
C) Revenues of Regulatory and Supervisory Agencies	**1.41**	**1.59**	**12.76**	**110.55**	**1.4**	**0.2**
Budget Balance	**-4.64**	**-13.88**	**199.04**	**82.49**	**-16.8**	**-2.7**
Primary Balance	**41.32**	**34.85**	**-15.66**	**96.49**	**36.1**	**5.7**

Source: Ministry of Finance
*GNP growth rate for 2007 is from SPO Program of 2007.

According to the central government budget for 2008 that passed the Grand National Assembly of Turkey (GNAT) on December 14, central government spending for 2008 is set to increase by 9.4 percent to YTL 222.3 billion, and budget revenues are raised by 7.9 percent to YTL 204.6 billion over the 2007 budget. Thus, the primary surplus is expected to amount to YTL 38 billion, while the budget deficit will be YTL 18 billion, slightly over the 2007 target.

The central government's budget target for 2008 was based on the target for the consolidated public-sector primary balance/GDP ratio that fell to 5.5

percent from 6.5 percent in previous years. It is quite striking, however, that although the public sector was moving dramatically toward a balanced budget during 2002-2006, it saw a significant deficit in 2007, and the outlook for 2008 seems to signal a similar pattern. In other words, taking into account that the central government's budget target for 2008 has not improved from 2007, micro-level adjustments and measures, which are capable of strengthening the efficiency of the public sector, will be highly required for price stability in 2008.

In sum, aiming a 7.5 percent increase in 2008 for non-interest budget expenditures, which rose by 17.1 percent in 2007 over 2006, is considered reasonable in terms of curbing the expansionary impact of central government spending on domestic demand, but several adjustments that took effect during the election period and boosted government spending in 2007 remain of critical concern with regard to their lagged effects on budget expenditures in 2008. Besides, efforts to minimize the negative impact of the 2009 local elections on the 2008 budget are believed to be crucial for maintaining price stability.

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

	2005	March 2006	April 2007	August 2007	September 2007	December 2007
Realizations						
Primary Balance	**28.3**	**36.2**	**9.4**	**23.1**	**26.0**	**-**
Primary Balance (Excluding SEEs)	**23.6**	**34.6**	**7.3**	**19.8**	**23.1**	**-**
Central Government Budget	24.1	33.5	5.7	16.6	19.9	-
Overall Balance	**-4.2**	**-1.2**	**-6.6**	**-6.5**	**-10.3**	**-**
Central Government Budget	-11.5	-6.9	-11.2	-15.1	-19.0	-
Targets						
Adjusted Program						
Primary Balance	30.4	34.5	12.3	32.3	-	39.7
Primary Balance (Excluding SEEs)	26.7	31.8	11.7	31.1	-	37.2
Overall Balance	-19.7	-6.5	-6.6	-3.6	-	-6.5

* Figures for 2007 are provisional.
Note: Consolidated Public Sector = Central Government + 23 SEEs + Extra Budgetary Funds (Defense Industry Support Fund, Privatization Fund and Social Assistance and Solidarity Encouragement Fund) + Social Security Institutions + Unemployment Insurance Fund.
Overall Government = Consolidated Public Sector + Local Administrations + Revolving Funds + non-CGS SEEs.
Source: Treasury.

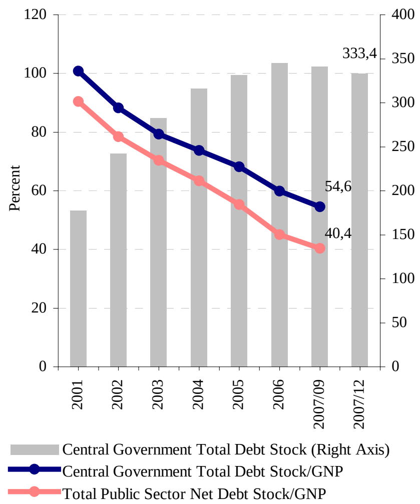
Although the consolidated public-sector primary balance provided a surplus of YTL 23.1 billion in August 2007, it remained YTL 9.2 billion below the program target and failed to meet the August target, which was set as a performance criterion (Table 6.2). Considering the fact that the program-defined central government primary balance posted only a surplus of YTL 24.9 billion in November, the end-2007 target for the program-defined consolidated public-sector primary balance of YTL 39.7 billion was not met and the total consolidated public-sector primary surplus over national income ratio was around 4 percent, missing the 6.5 percent target. As it is known, the public sector primary surplus/GDP ratio is projected to be 5.5 percent for 2008. Achieving this rate is of critical importance to secure the benefits of public finance for the past few years.

6.2. Developments in Debt Stock

Despite a budget deficit of YTL 13.9 billion, the central government debt stock decreased by 3.4 percent to YTL 333.4 billion at end-2007 compared to 2006, mainly owing to contributions from exchange rate changes by YTL 21.2 billion. Besides, net domestic debt grew YTL 8.9 billion, while net foreign debt went down by YTL 2.6 billion. Furthermore, the ratio of net total public debt stock to GNP amounted to 40.4 percent in the third quarter of 2007, maintaining the downward pattern of recent years (Graph 6.2.1), which is supposedly boosted by the substantial stabilization of growth rates, exchange rates and interest rates, coupled with gains from the primary surplus and privatization.

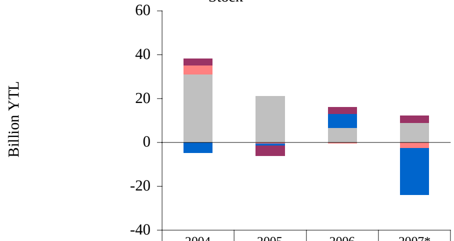
Graph 6.2.1. Public Debt Stock Indicators
(Billion YTL)

Public Sector Debt Stock Indicators



Source: Treasury.

Analysis of Change in Central Government Total Debt Stock



	2004	2005	2006	2007*
Parity Effect	3.0	-4.8	3.2	3.4
Total Exc. Rate Efeect	-4.6	-0.8	6.4	-21.2
Net External Borrowing	4.1	-0.6	-0.5	-2.6
Net Domestic Borrowing	31.2	21.1	6.7	8.9

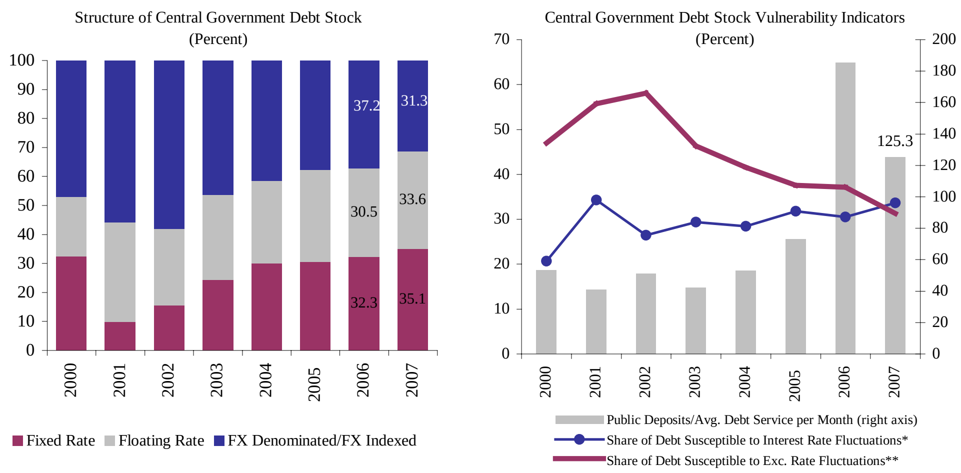
* Changes compared to 2005.
** Changes arising from the movements in USD/EURO and USD/SDR parities.
***Changes arising from the movements in YTL/USD parity.

Note: Changes in Net Debt denotes the change adjusted for the exchange rate and parity effect.
Source: Treasury, CBRT.

In 2007, the share of floating rate and fixed rate instruments in central government debt stock increased, while the share of instruments sensitive to exchange rate changes decreased (Graph 6.2.2). The Treasury, as stated in its 2008 Borrowing Program, plans to make a net YTL 3.9 billion domestic borrowing and YTL 3.4 billion foreign borrowing, totaling YTL 7.3 billion. Moreover, the Treasury will not issue any FX-indexed securities in 2008 and will limit the FX-denominated domestic debt rollover ratio to 60 percent. In this context, the debt stock, which is sensitive to exchange rate changes, will continue to have a declining trend in 2008. Besides, since the Treasury's domestic borrowing will largely be in fixed-rate instruments, the share of fixed-income instruments in the central government debt stock will increase.

In line with the financing strategy intended for reducing the liquidity risk, the ratio of public deposits to average monthly debt service ended 2007 at 125.3 percent. The Treasury is expected to maintain its policy of holding large reserves in 2008.

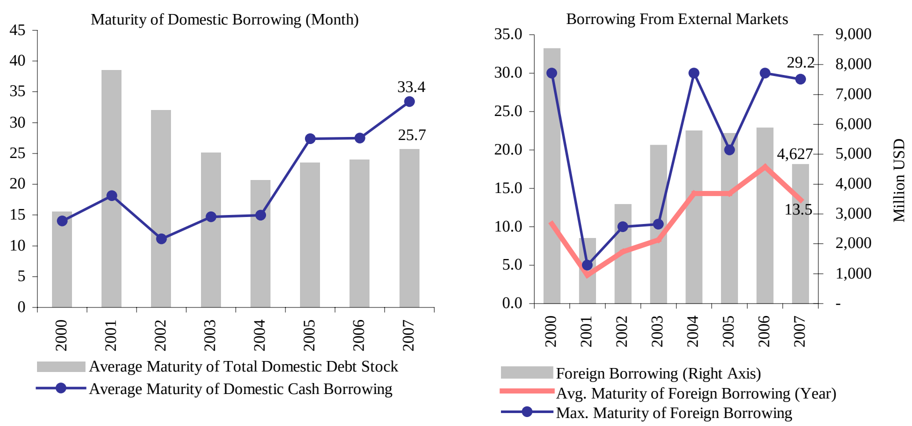
Graph 6.2.2. Structure of Central Government Debt Stock



*Debt stock sensitive to interest rates contains discounted securities with 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.

As the Treasury issued a record amount of 5-year floating rate and fixed coupon bonds in 2007, the average maturity of domestic cash borrowing trended significantly longer and extended to 33.4 months in December 2007. Likewise, the average maturity of total domestic debt stock also extended to 25.7 months in December. Moreover, bond issues yielded a USD 4.6 billion worth of long-term foreign debt in 2007 with an average maturity of 13.5 years (Graph 6.2.3).

Graph 6.2.3. Maturity of Borrowing from Domestic and External Markets



Source: Treasury, CBRT.

7. Medium Term Projections

In this chapter, updated assumptions about fundamental macroeconomic variables are summarized, and relating inflation and output gap forecasts are presented. In addition, major potential risks that can significantly change the forecasts are analyzed. As the forecast horizon is set to be two years, forecasts in this Report cover 2008 and 2009.

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. The assumptions underlying the forecasts were updated based on the data released since the October 2007 Inflation Report and assembled with the general outlook, analyses and expertise presented in previous chapters of this report.

The third-quarter GNP data have broadly matched the forecasts in the October 2007 Inflation Report. Accordingly, the contribution of domestic demand to growth increased due to the recovery in the private consumption demand, while the public sector contributed less and the contribution of net foreign demand turned substantially negative. The supply shock originating from the agricultural sector, the global credit turmoil and the lagged effects of monetary tightening curbed economic growth in the third quarter. Although domestic demand rebounded at a faster pace during the final quarter, the current data on economic activity indicates that this trend is not at a level to exert pressure on inflation.

Moreover, inflation and output gap forecasts are built up taking into account public sector budget targets, and it is assumed that government spending will have a reduced contribution to total demand in 2008.

In sum, the medium-term forecasts are based on the assumption that domestic demand and capacity conditions will continue to support the disinflation process in 2008.

In our October 2007 Inflation Report, the assumption for oil prices was set at 70 US dollar per barrel. Food inflation, on the other hand, was assumed to exhibit a gradual slowdown towards the values consistent with the medium term inflation target thanks to the high base from previous years. However, food and energy inflation turned out to be more persistent than we had envisaged, as the prices of crude oil and agricultural commodities continued to rise throughout 2007. These developments not only led our inflation projections for end-2007 to undershoot, but also necessitated an upward revision to our medium term forecasts.

Accordingly, we revised our assumption for oil prices up, to 85 US dollar per barrel in 2008. We now envisage that the lagged impacts of last year's drought and the elevated prices of agricultural commodities will cause processed food inflation to rise further and remain at relatively high levels, albeit down from a record high. In other words, we have based our revised inflation forecasts on a more cautious assumption for food prices compared to the previous Inflation Report.

The rate-cut cycle that started in September 2007 continued into the fourth quarter of the year. Despite the recent rate cuts, monetary policy can still be considered to be in the restrictive territory. Although medium term interest rates followed a downward trend in the past quarter, 2-year real rates still fluctuate between 9 and 10 percent and support the disinflation process. Therefore, we have based our forecasts on the assumption that the monetary policy stance continues to support the disinflation process.

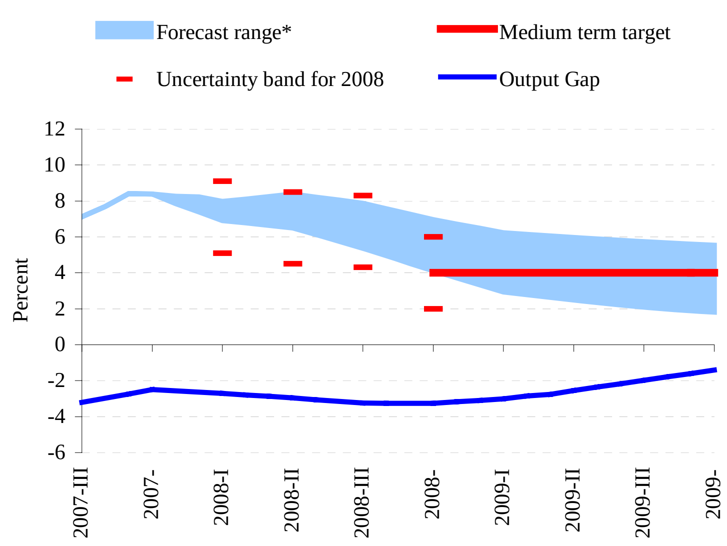
Other significant variables providing input to medium term inflation forecasts are the assumptions related to external economic activity, which are composed of fundamental macroeconomic variables of the euro area such as interest rates, inflation and growth, and of projections pertaining to the course of international commodity prices and risk premium. Our assumptions related to the euro area derive from the January 2008 release of "Consensus Forecast" results. In this respect, euro area growth forecasts are revised downward while inflation forecasts are revised upward, compared to the previous quarter. Accordingly, economic growth and inflation in the euro area are expected to be around 1.8 and 2 percent, respectively, in 2008. In addition to euro area, estimates for other developed economies and changes in international liquidity conditions are also closely monitored in developing the forecasts. In this sense, we assumed that the economic activity in developed countries has decelerated at a mild rate and their risk premium has thus remained broadly unchanged.

7.2. Medium-Term Outlook

This part presents the medium-term inflation and output gap forecasts developed within the framework of the assumptions and projections explained in Part 7.1.

Accordingly, we forecast inflation, with 70 percent probability, to be between 4.1 percent and 6.9 percent (midpoint 5.5) at the end of 2008, and between 1.8 percent and 5.5 percent (midpoint 3.7) at the end of 2009 (Graph 7.2.1). The forecast is based on a scenario in which policy rates display a limited decline in 2008. Main message of the forecast is that continuation of the gradual easing cycle that started in September 2007 will remain conditional on favorable data and developments. In that sense, the current policy stance envisages a more moderate decline in policy interest rates than indicated in the previous Inflation Report.

Graph 7.2.1. Inflation and Output Gap Forecasts



*Forecast range corresponds to the 70 percent confidence interval..

Inflation forecasts for end-2008 are revised upward from the previous reporting period, due to raised assumptions for sharply rising administered prices, and for oil and food prices. Revised forcasts suggest that it may take longer to bring inflation down to the target than envisaged in our previous Inflation Report. Therefore, in the absence of a significant correction in food inflation, headline inflation will most likely exceed the target level of 4 percent at the end of 2008.

The lagged effects of monetary tightening and the global credit turmoil have curbed domestic demand growth. Besides, the waning external demand driven by the slowdown in global economy also put downward pressure on economic growth. All in all, the output gap will remain negative throughout 2008, and based on the abovementioned policy stance, aggregate demand conditions will support the downward trend in the underlying inflation (Graph 7.2.1).

The above policy perspective is built on currently available data and assumptions and should by no means be perceived as a commitment of the CBRT, and will certainly be modified in response to a change in economic conditions and assumptions underlying the above forecasts.

7.3. Risks and Monetary Policy

There are both upside and downside risks to the inflation and monetary policy outlook for the upcoming period:

The main upside risk factor for the current medium term inflation outlook pertains to the potential second round effects of the accumulated supply shocks, which may also create a higher than expected inflation inertia, as currently manifested in the medium term inflation expectations. So far, the second round impact of food prices has been limited and confined to selected sub-components of the overall index such as restaurants and catering services. The potential second round impact of elevated food and energy prices, however, should not be overlooked. Therefore, the CBRT will keep a close eye on the price setting behavior along with various core inflation measures. The policy strategy will be to tolerate the first-round impact on inflation resulting from food, energy and one-off adjustments in administered prices, yet to remain responsive to the second round effects.

The CBRT closely monitors the developments in global markets. The potential impact of ongoing difficulties in the US credit markets, on the financial markets and the real economy, continue to create uncertainty about the course of the global economy. Our baseline scenario assumes a soft landing in developed economies, with no major portfolio shock on the Turkish financial markets. However, the probability of a sharper than expected slowdown should not be ruled out. While the possibility of a sharper than envisaged slowdown in global economic activity, through a portfolio shock and its potential impact on the exchange rates, may constitute an upside risk to the short-term inflation outlook, it also poses downside risks to inflation in the medium term through a possible weakening in external demand and domestic credits.

It should be underlined that fiscal discipline of the past several years has, by reducing the long-term risk premium, been the key force allowing the achievement of robust output growth during a remarkable disinflation period. Maintaining the prudent fiscal policy, during an episode of worsening risk appetite, is even more critical in preserving the resilience of the economy.

Our medium term projections are based on the assumption that government expenditure targets will be met in 2008. Moreover, we assume that any extra need to readjust the primary budget balance will be implemented primarily through expenditure cuts rather than hikes in indirect taxes. Therefore we envisage no major shocks arising from administered price adjustments, except the hikes in electricity and natural gas in January 2008. Any deviation from this assumption may alter the inflation and monetary policy outlook.

The recent increase in end-user energy prices may continue to exert some temporary upward pressure on headline inflation in the coming months. However, these adjustments will also help lower inflation in the medium term as they contribute to a prudent fiscal stance and facilitate an expansion of the domestic energy production. Hence, the CBRT will not react to these price adjustments, except to contain second-round effects.

Developments in food prices are still considered as an important risk to the short-term inflation outlook, as food items constitute more than one fourth of the CPI basket. The course of food inflation is highly dependent on domestic weather conditions as well as global developments. We have based our medium-term inflation outlook on a more cautious assumption for food prices compared to the previous report. Yet, there is a significant chance of a downward correction in unprocessed food inflation, especially given the base effect created by the last two years' elevated food prices. On the other hand, it is also possible that global developments and increasing demand for certain food items may continue to push up food prices. Therefore, food prices continue to pose risks to the inflation outlook on both sides.

So far, Turkish economy has been resilient to reappraisal of risks in global financial markets. Taking into account the continued uncertainty over global economy, however, the support from fiscal policy and structural reforms are critical in shielding the economy against possible further deterioration in global sentiment. In this respect, efforts to move the European Union accession process forward and to implement structural reforms envisaged in the economic program remain crucial. In particular, advances in structural reforms enhancing quality of fiscal discipline and raising productivity are monitored closely by the CBRT with regard to their implications on macroeconomic and price stability.

GRAPHS

4. SUPPLY AND DEMAND DEVELOPMENTS

5. FINANCIAL MARKETS AND FINANCIAL INTERMEDIATION

6. PUBLIC FINANCE

7. MEDIUM TERM PROJECTIONS

TABLES

ABBREVIATIONS

ABCP	The Asset-Based Commercial Paper
AMA	Automotive Manufacturers Association
BoC	Bank of Canada
BoE	Bank of England
BoJ	Bank of Japan
CBRT	Central Bank of the Republic of Turkey
CDS	Credit Default Swap
CPI	Consumer Prices Index
CSRA	Credit Suisse Risk Appetite Index
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EEM	Emerging Markets Index
EU	European Union
Fed	Federal Reserve Bank of America
FDI	Foreign Direct Investments
FOMC	Federal Open Market’s Committee
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNP	Gross National Product
GNTA	Grand National Assembly of Turkey
GS	Goldman Sachs
HICP	Harmonized Index of Consumer Prices
IEA	International Energy Agency
ISE	Istanbul Stock Exchange
LME	London Metal Exchange
LIBOR	London Interbank Offered Rate
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital Index
OECD	Organisation for Economics Co-Operation and Development
PBC	Bank of China
PMI	Purchasing Managers Index
SCA	Special CPI Aggregates
SCT	Special Consumption Tax
SNB	Swiss National Bank
SPI	Standardized Precipitation Index
SPO	State Planning Organization
TAF	Term Auction Facility
TEA	Turkish Exports’ Assembly
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VAT	Value Added Tax
YTL	New Turkish lira