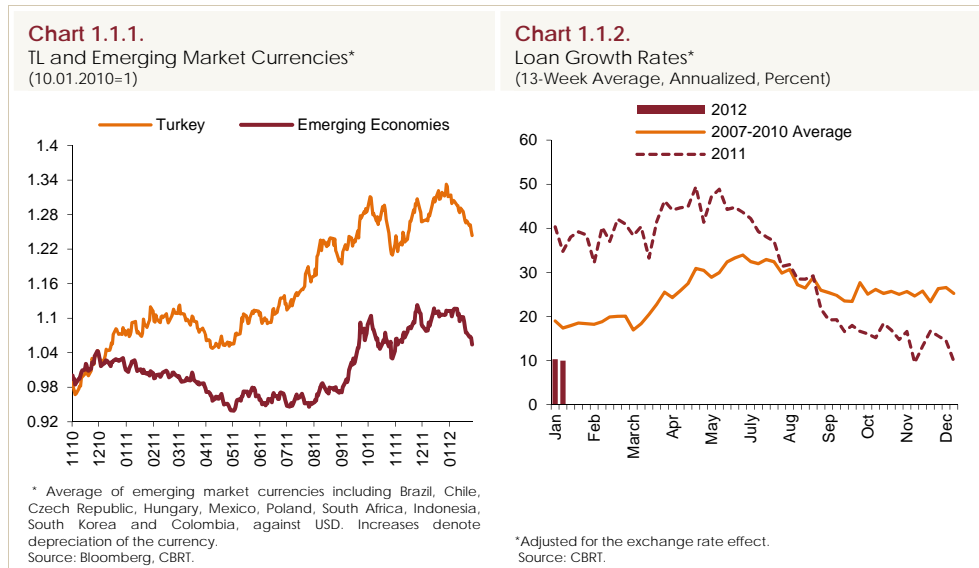


1. Overview

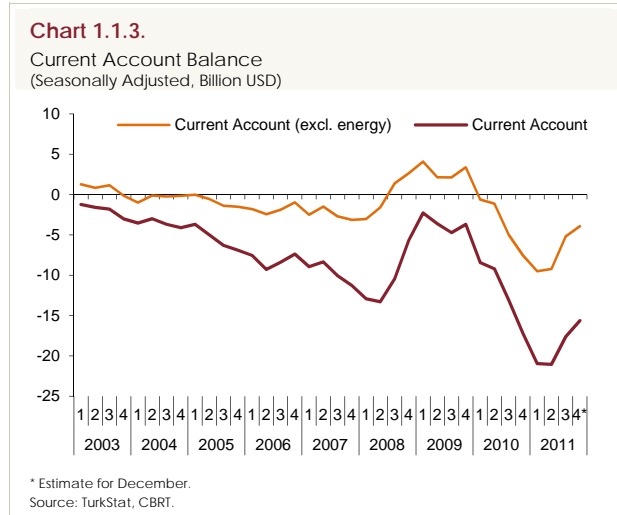
Since the publication of the October 2011 Inflation Report, concerns over sovereign debt sustainability across the Euro Area have continued to weigh on the global economic outlook despite the adopted policy measures. Growth forecasts were revised downwards at a global scale particularly in the Euro Area. Thus, expectations for a further delay in the normalization of monetary policy in advanced economies grew stronger. Despite a relative improvement in the risk appetite as of the onset of 2012, uncertainties regarding the solution of the Euro Area problems persist. Coupled with the increased risk of contagion, this feeds into fragility in global financial markets, confirming the significance of adopting a flexible monetary policy framework.

1.1. Monetary Policy Implementation and Monetary Conditions

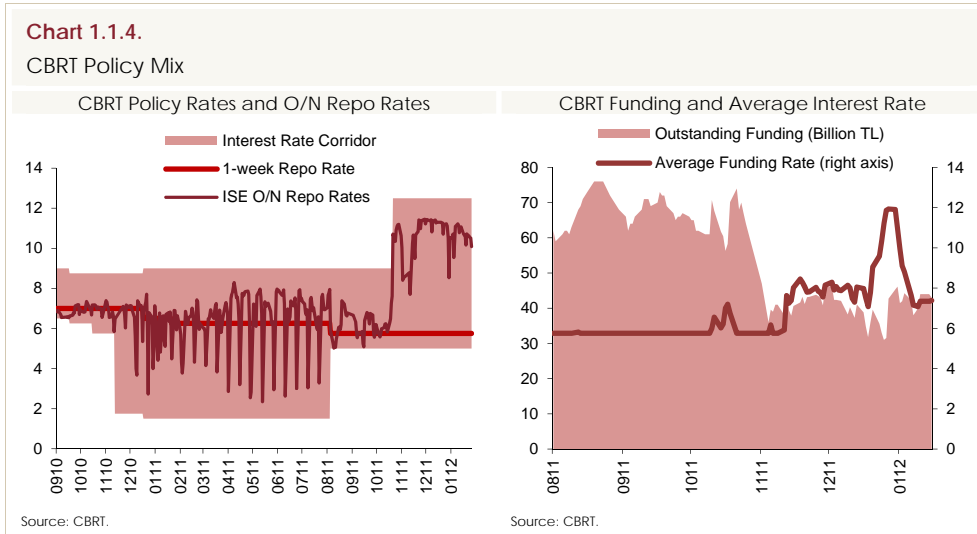
In the face of heightened macro financial risks in the first half of 2011, the Central Bank of the Republic of Turkey (CBRT) opted for gradually leading the economy towards a more balanced growth composition. Accordingly, in order to bring loan growth rates to reasonable levels, necessary measures were taken with the support of other institutions, while also reacting to excessive exchange rate deviations from economic fundamentals on either side (Charts 1.1.1 and 1.1.2).



Data releases for 2011 point that the balancing of the economy has started as anticipated. Accordingly, the contribution of net exports to growth increased notably in the second half of the year, while the current account balance posted a remarkable improvement (Chart 1.1.3).

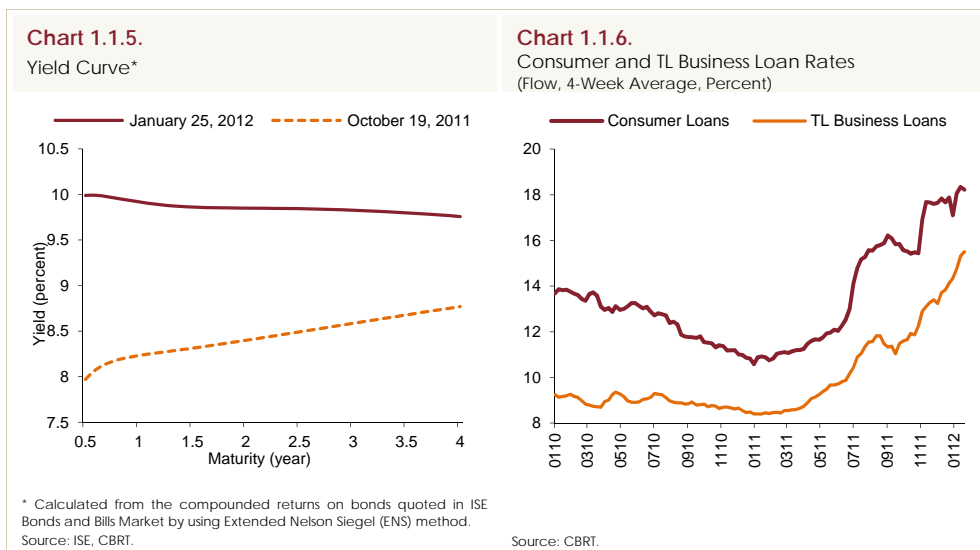


Despite attaining desired outcomes regarding macro financial risks, soaring inflation in the last quarter required a revision in the monetary policy stance. The ongoing deterioration in the global risk appetite as of August led to an excessive depreciation in the Turkish lira, posing risks on the inflation outlook. In addition, high price adjustments in administered products in October caused a more-than-anticipated rise in short-term inflation. In order to prevent deterioration in inflation expectations, the CBRT has delivered an important tightening in monetary policy since October. Accordingly, the interest rate corridor was widened upwards and the average funding cost was raised significantly by adjusting the amount of TL funding through 1-week repo auctions, when deemed necessary (Chart 1.1.4).



The Monetary Policy Committee (MPC) noted that the tight monetary policy stance should be maintained for a while to ensure that the inflation outlook is consistent with the medium term targets. The MPC also stated that keeping the flexibility of the monetary policy is necessary given the ongoing uncertainties regarding the global economy.

The currently downward sloping yield curve points to a tight monetary policy stance (Chart 1.1.5). Additionally, loan interest rates have recorded a notable increase since October (Chart 1.1.6). Hence, loan growth rate declined to more reasonable levels towards the year-end (Chart 1.1.2).

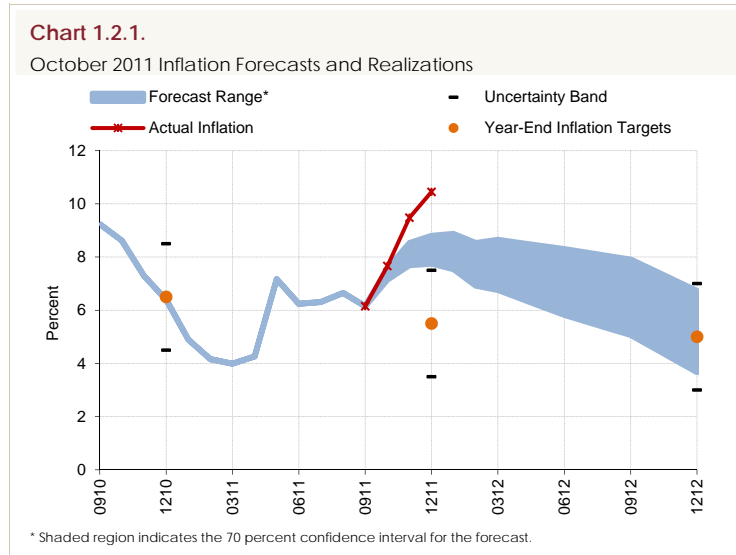


In sum, the last quarter of 2011 was marked by ongoing tightening in monetary and financial conditions and a pronounced deceleration in loans.

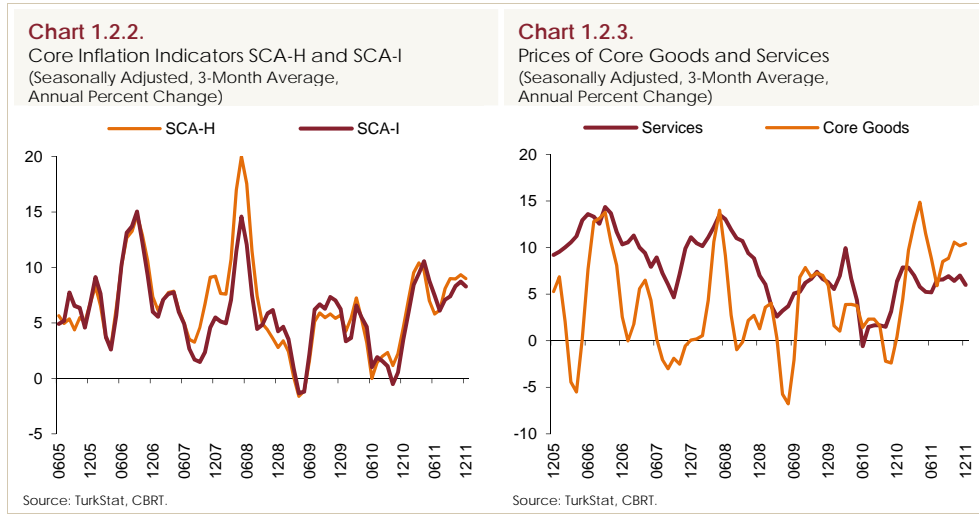
1.2. Macroeconomic Developments and Main Assumptions

Inflation

Having climbed to 10.45 percent at end-2011, inflation remarkably exceeded the October forecasts amid more-than-envisioned increases in unprocessed food prices. The ongoing depreciation of the Turkish lira as a result of the deterioration in the risk appetite was another factor leading to a deviation in short-term forecasts (Chart 1.2.1).



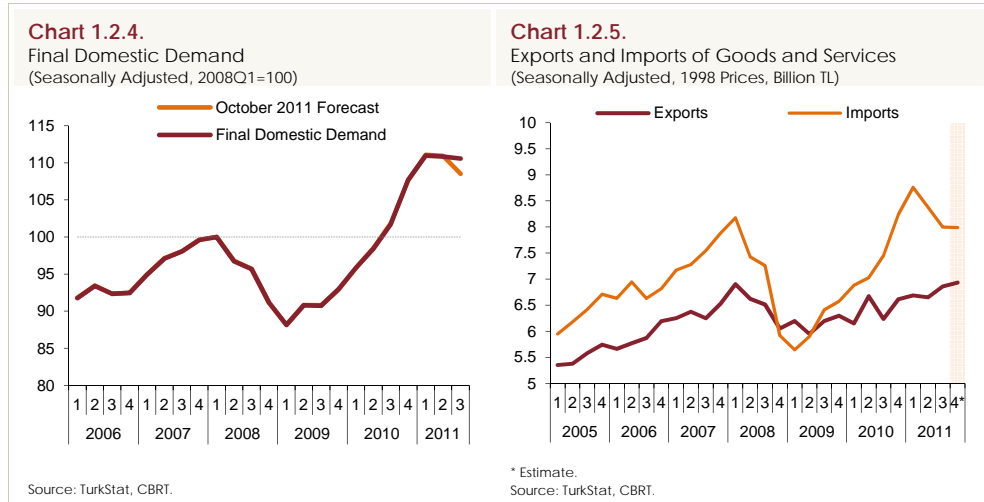
Owing to the lagged effects of the exchange rate developments, core inflation indicators remained on the rise during the final quarter (Chart 1.2.2). Meanwhile, underlying services inflation followed a moderate course, indicating that the secondary effects were limited (Chart 1.2.3).



Supply and Demand Developments

Gross Domestic Product (GDP) data pointed that domestic demand proved stronger in the third quarter of 2011, compared to the outlook presented in the October Inflation Report (Chart 1.2.4). Thus, output gap forecasts were revised upwards in this period. Growth was balanced further as expected (Chart 1.2.5). Despite the weak course of the global economy, exports continued to increase, while the demand for imported goods and services sustained a fall. Consequently, the net external demand contributed positively to annual growth for the first time after an extended period.

Indicators in the last quarter of 2011 point that final domestic demand remains flat and the balancing of the economy is ongoing as envisaged. Owing to the monetary tightening, final domestic demand is expected to grow moderately in the forthcoming period, as suggested by the recent loan and orders data (Chart 1.1.2). Accordingly, inflation forecasts are based on the assumption for a further deceleration in domestic demand by early 2012.



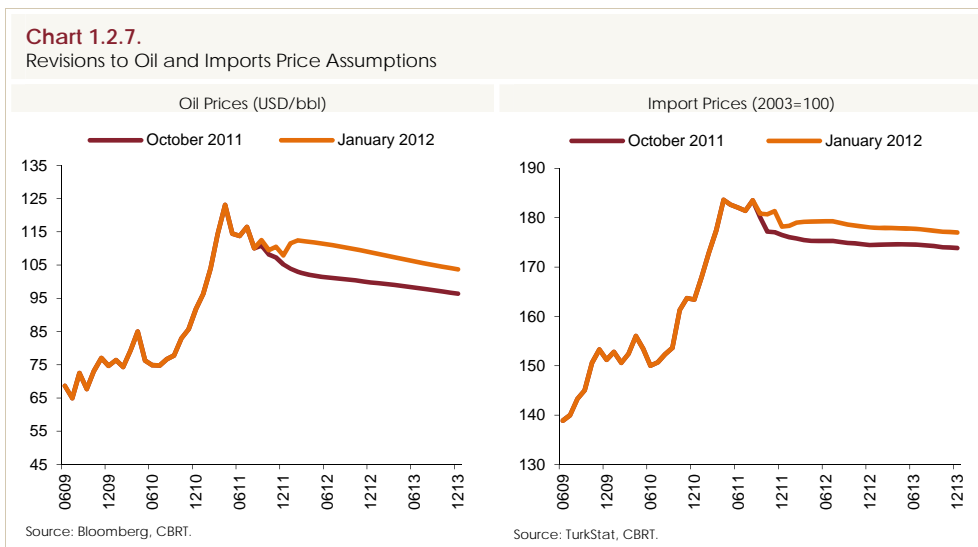
Growth forecasts were revised significantly downwards, especially for the Euro Area, in the inter-reporting period. Thus, projections on export-weighted global growth index for Turkey also point to a slower pace of growth for external demand (Chart 1.2.6). Hence, inflation forecasts are based on an outlook of weaker external demand conditions compared to the previous period.



In sum, the output gap was revised upwards for the second half of 2011 amid the stronger-than-anticipated economic activity in the third quarter. However, due to deterioration of the global growth outlook, aggregate demand conditions are expected to provide a stronger support to disinflation in the medium term compared to the previous reporting period.

Commodity and Food Prices

Assumptions for commodity and oil prices were revised slightly upwards. Considering the recent developments and futures prices, assumptions for oil prices were revised upwards from USD 100 to USD 110 per barrel for 2012, and to USD 105 for 2013. Accordingly, assumptions for import prices were also revised slightly upwards (Chart 1.2.7). In addition, the assumption for annual food inflation remained unchanged at 7.5 percent throughout the forecast horizon.

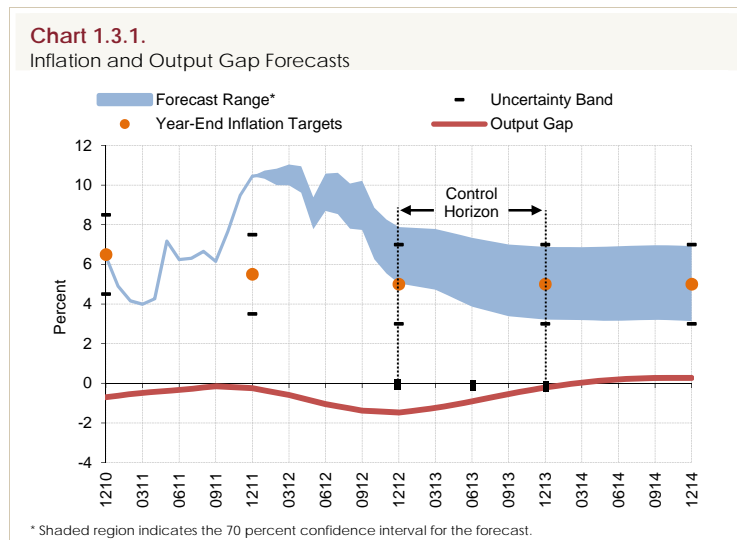


Fiscal Policy and Tax Adjustments

Regarding fiscal policy, the medium-term inflation forecasts take the outlook presented in the Medium Term Program (MTP) as given. Therefore, the baseline scenario envisages no significant change in the ratio of primary expenditures to GDP, while assuming that the public debt to GDP ratio will continue to fall. On the other hand, baseline scenario envisages that tobacco prices will remain unchanged throughout 2012. For 2013, tobacco prices are assumed to increase in tandem with the tax adjustments in October 2011. Moreover, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and automatic pricing mechanisms.

1.3. Inflation and Monetary Policy Outlook

Forecasts are based on the assumption that tight monetary policy stance will be sustained for a while, hence, annual loan growth rate will hover around 15 percent and the Turkish lira will appreciate mildly. Accordingly, inflation is expected to be, with 70 percent probability, between 5.1 and 7.9 percent with a mid-point of 6.5 percent at the end of 2012, and between 3.3 and 6.9 percent with a mid-point of 5.1 percent at the end of 2013. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).



In sum, demand and cost conditions have remained virtually unchanged in the inter-reporting period, while inflation forecasts for end-2012 were revised upwards due to higher initial values.

Cumulative increases in the exchange rate and commodity prices coupled with surging unprocessed food prices and soaring administered prices pushed inflation higher in 2011. Inflation is projected to remain flat in the first quarter, and assume a gradual downtrend starting from the second quarter (Chart 1.3.1). The tight monetary policy stance implemented by the CBRT since October is expected to contain the secondary effects, thus causing inflation to follow a downward trend as the accumulated effects of the temporary price changes on annual inflation fade away gradually. Accordingly, inflation is estimated to display a sharp decline particularly in the last quarter of 2012.

In view of the unfavorable fluctuations in the economic activity likely to be brought about by lowering inflation from 10.45 percent to 5 percent within 12 months, the baseline scenario envisages a time span of about 18 months to bring inflation back to the target. In other words, inflation is envisioned to reach the target of 5 percent by mid-2013 (Chart 1.3.1). However, the target might also be reached by the end of 2012, should the risk appetite improve markedly in the forthcoming period and the capital flows to emerging economies re-accelerate, leading to a stronger-than-expected appreciation of the Turkish lira.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and Monetary Policy

Inflation will remain elevated in the short term, posing risks regarding the secondary effects. The cumulative rate of increase in the consumer prices, which will continue to reflect on inflation till the last quarter of 2012, hit 5.66 percent in the last quarter of 2011. Annual inflation, measured as the 12-month rate of change in prices, is expected to remain significantly above the target until the year-end, even if the underlying inflation falls back to levels consistent with the target. Although the monetary tightening by the CBRT since October has contained the secondary effects, inflation expectations and the pricing behavior will be monitored closely in the upcoming period, and necessary measures will be taken to keep medium-term inflation outlook consistent with the target.

Uncertainties regarding global economy will remain critical, thus requiring flexibility in monetary policy. The baseline scenario underlying the medium-term projections assumes that problems in the Euro Area will be solved gradually with no further deterioration in the global outlook. However, the probability that the solution of the Euro Area problems may be protracted and painful poses downside risks regarding global growth and risk appetite. On the other hand, perceptions regarding global economic outlook may turn more favorable than expected, should the measures taken towards the solution be finalized sooner and more decisively than envisaged. Accordingly, the risk appetite may

improve amid the ongoing quantitative easing policies pursued by major central banks, accelerating capital flows to emerging economies. Overall, the ongoing Euro Area problems and uncertainties about the effectiveness of the adopted measures imply further volatility in the global financial markets in the forthcoming period, thus necessitating a flexible monetary policy, which utilizes multiple instruments. The CBRT will continue to monitor global developments closely, and take the required measures promptly.

Another risk factor in the forthcoming period is the uncertainty regarding oil prices. Although the weak course of the global economy dampens commodity prices, the recently manifesting problems regarding oil supply pose upside risks to energy prices. Should such a risk materialize, the CBRT will not react to temporary price movements, yet will not tolerate any deterioration on expectations.

The CBRT monitors fiscal policy developments closely while formulating its monetary policy. The baseline scenario forecasts of the Report are based on the MTP framework, therefore assuming that fiscal discipline will be maintained. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

In the period ahead, monetary policy will continue to focus on achieving price stability on a permanent basis, while observing financial stability. To this end, the impact of the macroprudential measures taken by the CBRT and other relevant institutions on the inflation outlook will be assessed carefully. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline, thereby reducing the saving deficit will contribute to the relative improvement of Turkey's sovereign risk and support price and the financial stability. Making progress in this direction will also provide room for monetary policy maneuver, and support the social welfare by keeping interest rates permanently at low levels. In this respect, taking necessary steps towards implementation of the structural reforms envisaged by the MTP is of utmost importance.