Central Bank of the Republic of Turkey

PRESS CONFERENCE FOR THE PRESENTATION OF THE INFLATION REPORT

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29 April 2010, Ankara

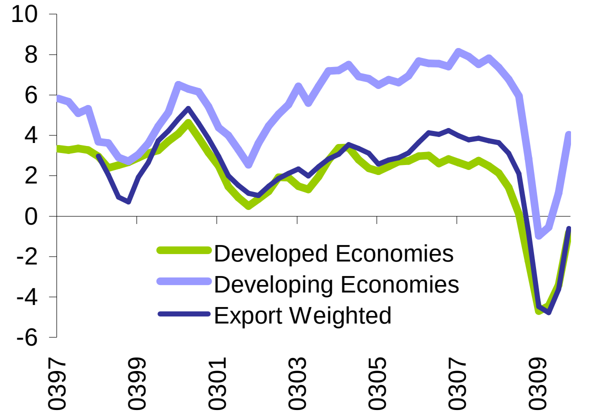
Distinguished Guests and Members of the Press,

Welcome to the press conference held to convey the main messages of the April 2010 Inflation Report, one of the most important communication tools of the inflation-targeting regime of the Central Bank.

The report typically summarizes the economic framework addressed in monetary policy decisions, elaborates global and domestic macroeconomic developments and presents the medium-term inflation forecasts, which have been revised in view of previous quarter developments, along with the monetary policy stance.

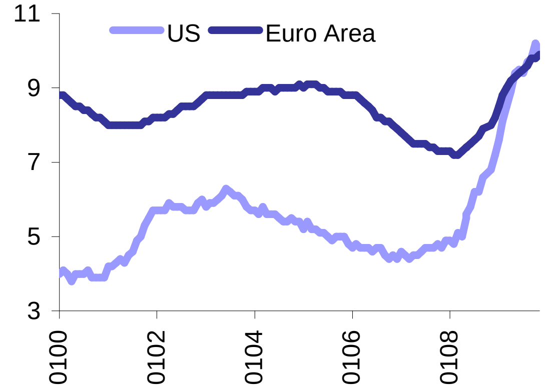
Before moving on to the Central Bank's assessments on the inflation outlook and economic activity, which I will share with you in detail shortly, I would like to summarize the current global conditions. The recovery in global economic activity and the normalization of the international financial system have continued during the first quarter of 2010 (Figure 1). However, distressing levels of government debt, lingering problems across credit markets, and high levels of unemployment rates, all suggest that completely resolving problems across developed economies is not likely over the near term (Figure 2). Although the recovery across developing economies seems to be stronger, ongoing problems across developed economies—with their prominent role in global trade—still create downside risks for developing economies. Moreover, constraints related to external finance remains as a potential factor that might delay the recovery in many developing economies.

Figure 1: Aggregated Growth Rates
(Percent)



Source: Bloomberg, CBT.

Figure 2: Unemployment Rates in Developed Countries
(Percent)

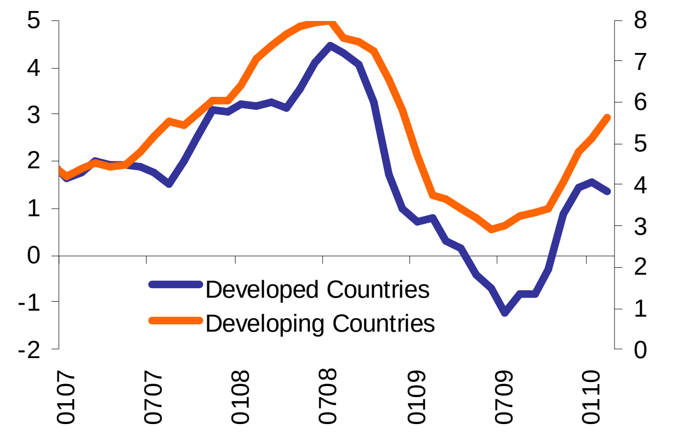


Source: Bloomberg.

Notwithstanding the lingering uncertainties regarding medium-term growth, developing economies faced inflationary pressures stemming from a relatively rapid rebound in economic activity, base effects, and ongoing increases in commodity prices. In this regard, inflation dynamics in developed and developing countries have started to decouple since the first quarter of 2010 (Figure 3). This decoupling is more pronounced in core inflation (Figure 4).

Figure 3: Consumer Price Inflation in Developed and Developing Countries

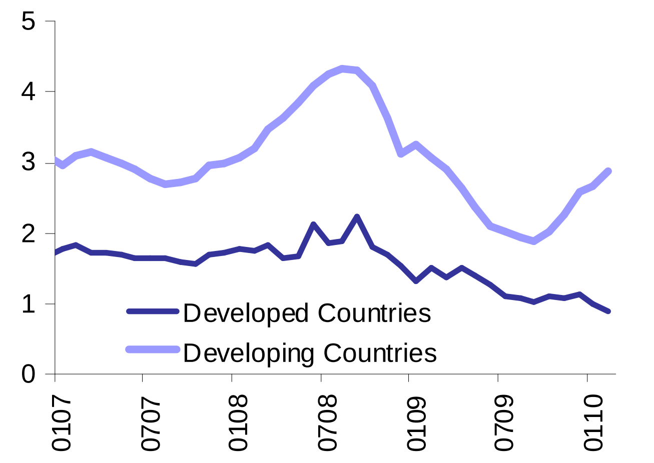
(Annual Percentage Change)



Source: Bloomberg, CBT.

Figure 4: Core Consumer Price Inflation in Developed and Developing Countries

(Annual Percentage Change)

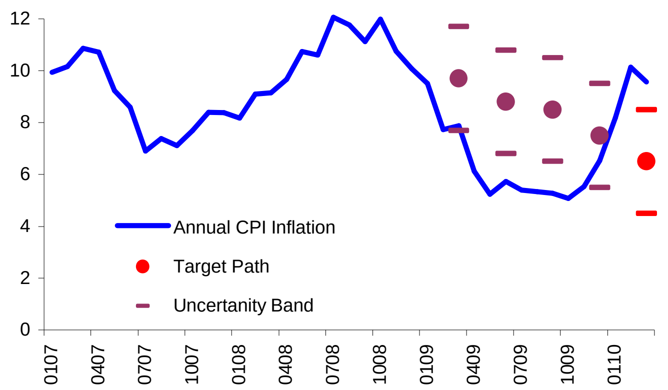


Source: Bloomberg, Datastream, CBT.

1. Inflation Developments

The inflation outlook in Turkey changed in line with the developments I have just mentioned pertaining to developing countries. However, in addition to these factors, the rise in inflation can largely be attributed to the high-rates price increases linked to the January tax hikes in fuel, alcoholic beverages and tobacco products. Moreover, the rate of change in unprocessed food prices also led the rise in inflation in Turkey to be relatively more pronounced. Therefore, annual consumer inflation continued to rise and pushed inflation up by around 3 percentage points to 9.56 percent during the first quarter of 2010, compared to figures of end-2009 (Figure 5).

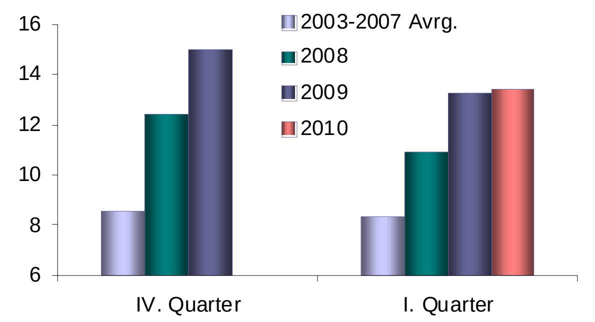
Figure 5: Annual Inflation and Path Consistent with the Target



Source: TurkStat, CBT.

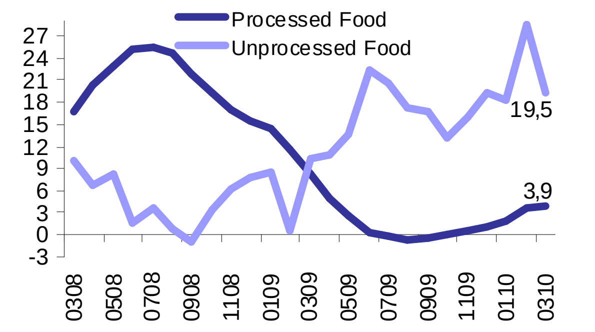
An analysis of the subcategories with respect to the rise in inflation indicates that unprocessed food prices displayed the highest quarterly increase in the index history in the first quarter of 2010, as was the case in the last quarter of 2009 (Figure 6). This increase is mainly attributable to the hikes in meat prices. Structural reasons led domestic supply to fall resulting in a remarkable increase in livestock prices. This hike, in turn, had significant effects on both processed and unprocessed food prices (Figure 7).

Figure 6: Unprocessed Food Prices
(Quarterly Percentage Change)



Source: TurkStat, CBT.

Figure 7: Food Prices
(Annual Percentage Change)

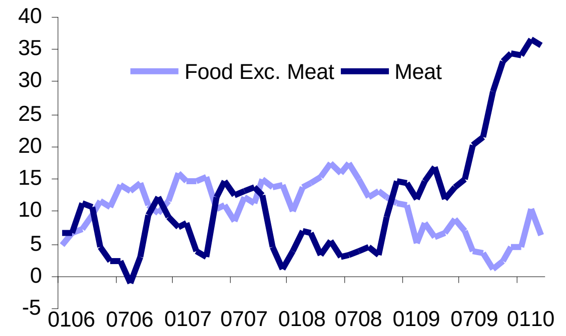


Source: TurkStat, CBT.

Thus, the contribution of meat and meat products to annual inflation reached 1.67 points by March. This reflects a situation mainly exclusive to Turkey. As a matter of fact, as illustrated in the slide, meat prices went up by 35 percent in Turkey within the last year, while no significant change was observed in meat prices in other countries (Figures 8 and 9).

Figure 8: Food Prices Including and Excluding Meat*

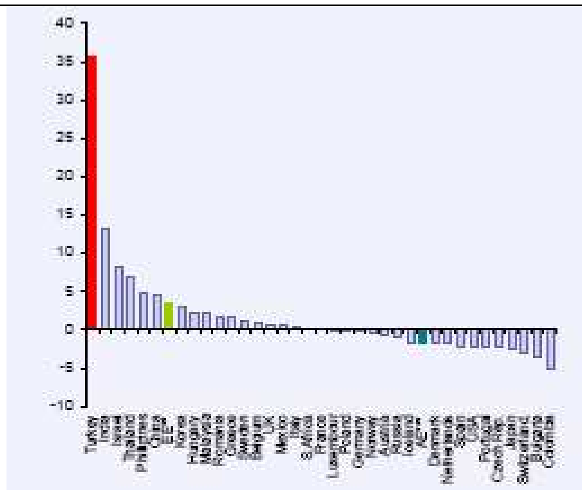
(Annual Percentage Change)



* Includes processed and unprocessed meat prices.
Source: TurkStat, CBT.

Figure 9: Meat Group Inflation*

(Annual Percentage Change)

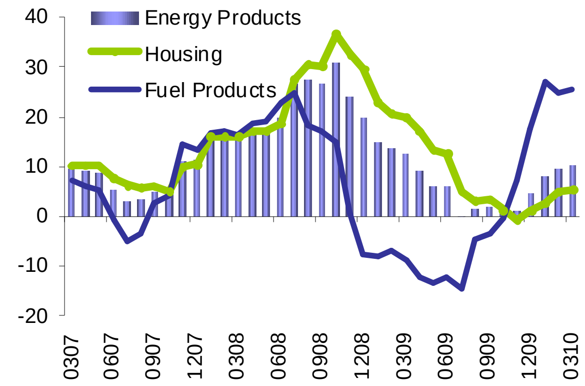


* As of Mart 2010. Due to data limitations, calculations for Japan, UK, Brazil, South Africa and Malaysia are as of February 2010, for China as of January 2010, and for India as of December 2009. ** Average for emerging economies.
*** Average for advanced economies.
Source: Eurostat, OECD, Datastream, web sites of selected central banks, CBRT.

Along with the surge in meat prices, vegetable prices increased to relatively high levels and led the trend of increase in food prices to become more pronounced. As a consequence, in the first quarter, food group inflation realized above our projections presented in the January Inflation Report.

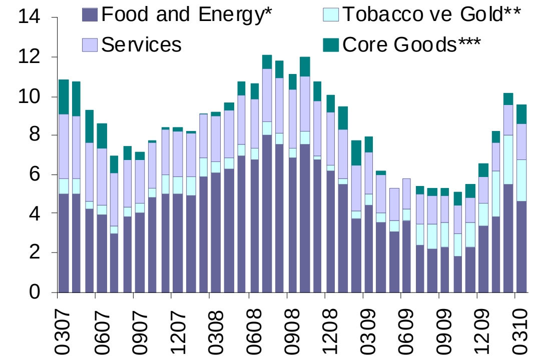
Meanwhile, energy prices registered a significant increase in the first quarter of 2010 due to the January tax adjustments and the low base effect generated by plummeting prices in the same period of 2009 (Figure 10). We estimate that owing to the base effect, annual inflation in the energy group will continue to rise in the second quarter of 2010 as well. Accordingly, due to tax adjustments and price hikes in food, energy and tobacco, the contribution of food, energy and tobacco products to annual inflation has reached 6.7 percentage points by the end of the first quarter (Figure 11).

Figure 10: Energy Group Prices
(Annual Percentage Change)



Source: TurkStat, CBT.

Figure 11: Contribution to Annual CPI



* Food and Energy: Food and non-alcoholic beverages and energy.

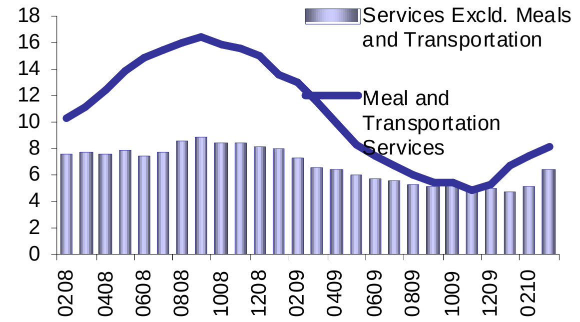
** Tobacco and gold: Alcoholic beverages, tobacco products and gold.

***Core Goods: Goods excluding food, energy, alcoholic beverages, tobacco and gold.

Source: TurkStat, CBT.

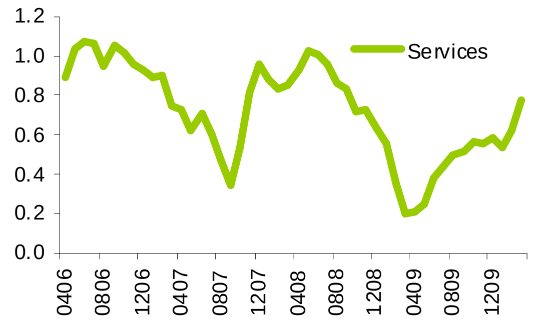
The impact of soaring food and energy prices on catering and transport services became more significant in the first quarter of 2010 (Figure 12). Consequently, annual services inflation, which has been declining since the third quarter of 2008, increased by 1.9 percentage points in the first quarter of 2010. Seasonally adjusted data also indicate that price increases in the services group accelerated compared to the previous quarter (Figure 13).

Figure 12: Services Group Prices
(Annual Percentage Change)



Source: TurkStat, CBT.

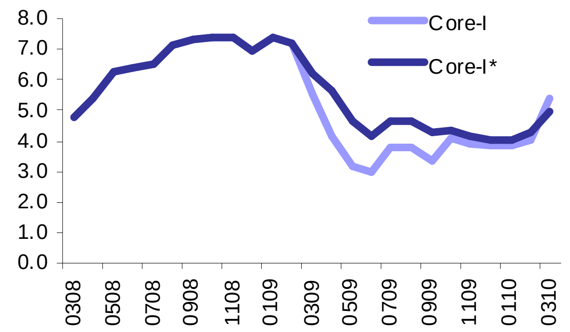
Figure 13: Services Prices
(Seasonally-adjusted, 3-month averages)



Source: TurkStat, CBT.

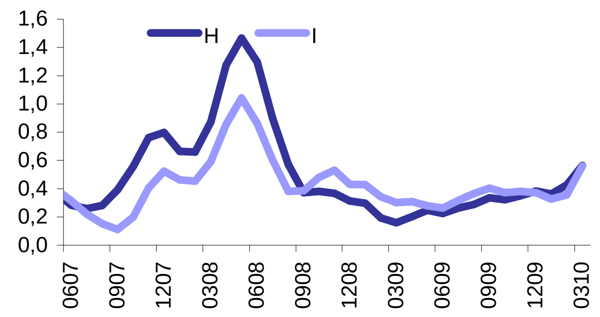
The low base of the previous year caused by the tax cuts in durable goods and the inventory destocking process have been major factors accounting for the increase in core inflation indicators (Figure 14). Reverberations of the rise in cost factors and the limited rebound in demand are also seen in the seasonally adjusted data (Figure 15).

Figure 14: Core Inflation Indicators I and I*
(Annual Percentage Change)



* Tax-adjusted indicators.
Source: TurkStat, CBT.

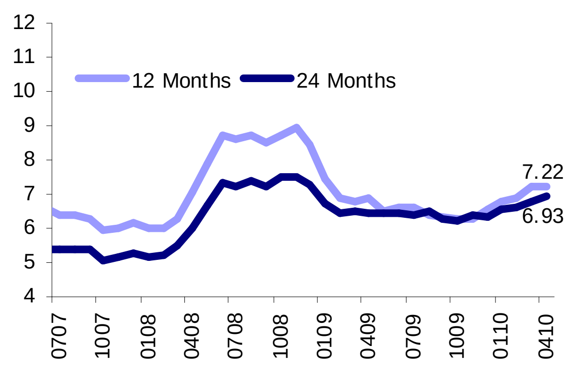
Figure 15: Core Inflation Indicators H and I
(Seasonally and tax-adjusted 3-month averages)



Source: TurkStat, CBT.

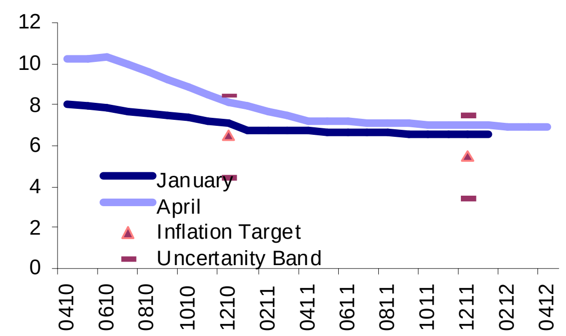
Parallel to these developments, medium-term inflation expectations, which started to increase in the last quarter of 2009, maintained this trend in the first quarter of 2010 (Figure 16). While expectations displayed an increase in all maturities, the difference between expectations and targets became wider (Figure 17). However, the increase in medium-term expectations remained relatively limited.

Figure 16: 12 and 24-Month Forward CPI Expectations*
(Annual Percentage Change)



* CBT Expectations Survey results from the second survey period
Source: CBT.

Figure 17: Inflation Expectations Curve*
(Annual Percentage Change)



* Calculated using linear interpolation of several maturity yields in the CBT Expectations Survey. Yields are from the second survey period.
Source: CBT.

2. Monetary Policy Response

After commenting briefly on inflation developments, I would now like to cover the policies pursued by the Central Bank during the last quarter.

Anticipating that inflation would decrease sharply following the last quarter of 2008, the Central Bank of Turkey (CBT) focused on alleviating the potentially harsh impact of the global financial crisis on the domestic economy. In this respect, the CBT has delivered sizeable cuts in policy rates, while providing liquidity support to facilitate the smooth operation of credit markets. Accordingly, policy rates were cut by 1025 basis points between November 2008 and November 2009. Considering the favorable developments in credit markets and the moderate recovery in economic activity, the Monetary Policy Committee (the Committee) has kept policy rates constant since December 2009 (Table 1).

Table 1: Monetary Policy Committee Decisions

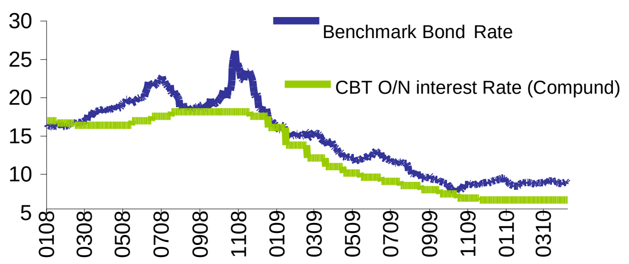
Meeting Dates	Interest Rate Decisions (Percentage Point)	Interest Rate (Percent)
19 November 2008	-0.50	16.25
18 December 2008	-1.25	15.00
15 January 2009	-2.00	13.00
19 February 2009	-1.50	11.50
19 March 2009	-1.00	10.50
16 April 2009	-0.75	9.75
14 May 2009	-0.50	9.25
16 June 2009	-0.50	8.75
16 July 2009	-0.50	8.25
18 August 2009	-0.50	7.75
17 September 2009	-0.50	7.25
15 October 2009	-0.50	6.75
19 November 2009	-0.25	6.50
17 December 2009	No change	6.50
14 January 2010	No change	6.50
16 February 2010	No change	6.50
18 March 2010	No change	6.50
13 April 2010	No change	6.50

Source: CBT.

Following the policy rate cuts implemented by the CBT since November 2008, market rates have plummeted to historic lows since the second quarter of 2009 (Figure 18). The stable course of market rates had implications on medium-term real rates in this period (Figure 19).

Figure 18: Developments in Interest Rates

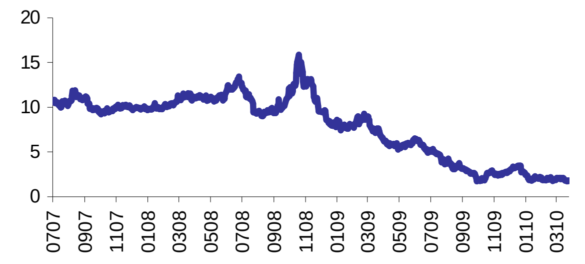
(Percent)



Source: ISE, CBT.

Figure 19: Medium-Term Real Rates Obtained from Government Securities*

(Percent)



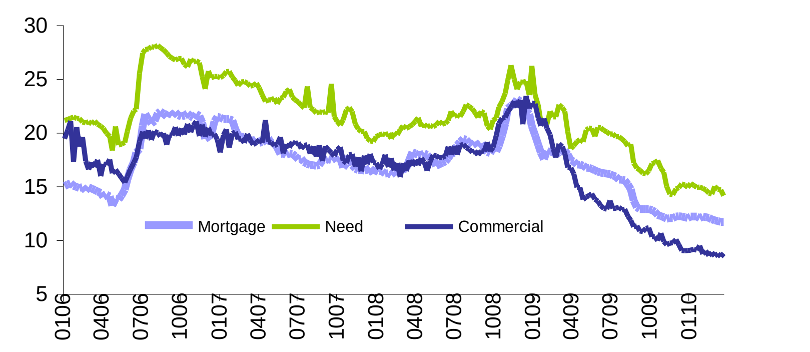
* 2-year real interest rates, calculated using 2-year nominal interest rates from the yield curve and inflation expectations from the CBT's Expectations Survey.

Source: ISE, Bloomberg, CBT.

Lower policy rates and stabilizing liquidity measures continued to be effective on money and credit markets during the first quarter of 2010. In this context, while consumer loan rates remained at historic lows, commercial loan rates continued to decline in the first quarter as well (Figure 20). With the easing of financial conditions, the expansionary impact of CBT's monetary policy has become more pronounced in this period.

Figure 20: Loan Rates*

(Percent)



*Consumer and commercial loans' rates are calculated on an annual basis.

Source: CBT.

As I have just mentioned, the pronounced elevation in inflation since the last quarter of 2009 had adverse effects on inflation expectations. Therefore, taking account of the adverse effects of the high inflation levels on expectations, albeit temporary, the

Central Bank signaled the transition to a more cautious stance as of March. Meanwhile, considering that the problems in the global economy have not been completely eliminated despite recent improvements, I would like to remind you that as we have already pointed out, policy rates may need to be kept at current levels for a while and may need to follow a low course for an extended period.

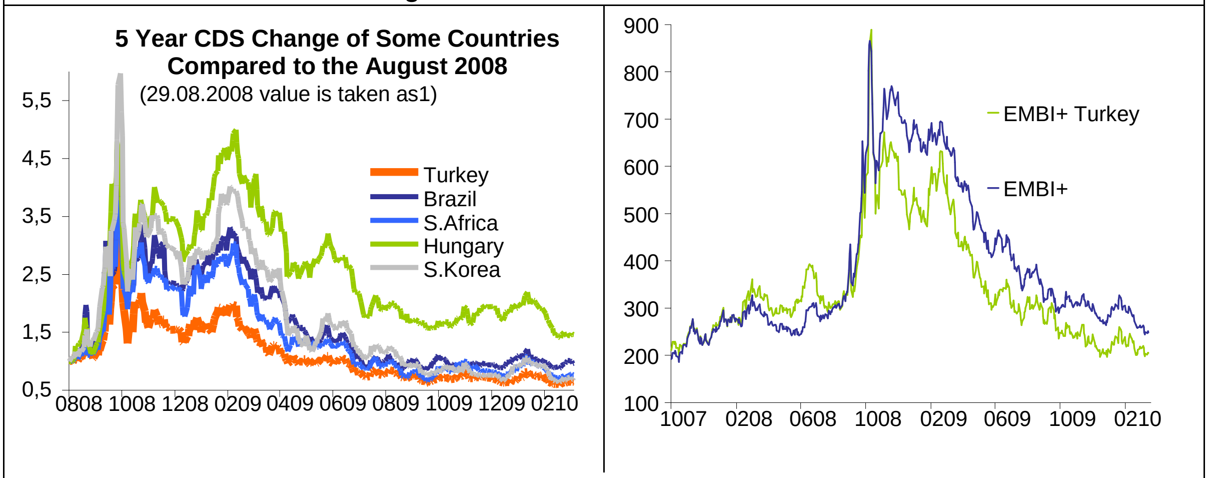
In the first quarter of 2010, central banks mostly implemented exit strategies from expansionary monetary policies and therefore the global monetary policy outlook became partially tighter. In the said quarter, a limited number of central banks tightened their monetary policy stance by increasing policy rates, while most of them kept their rates unchanged at low levels. In the meantime, these central banks started to terminate the expansionary monetary policy implementations, which are conducted with the use of unconventional policy tools. Accordingly, while drawing attention to the risks regarding pricing behaviors and taking account of the normalization in both money and credit markets; we decided to gradually withdraw some of the measures taken in the foreign exchange and Turkish lira markets during the crisis. Owing to the importance that we attach to transparency and predictability, I would like to remind you that we informed the public about the general framework of our exit strategy in our Press Release of 14 April 2010, before putting the strategy into practice.

3. Inflation and Monetary Policy Outlook

Now, I would like to share with you the monetary and financial conditions, as well as the economic outlook underlying our forecasts. Then, I will outline the Central Bank’s inflation forecasts presented in the Inflation Report that will be posted on our website shortly.

In the first quarter of 2010, as perceptions regarding recovery in the global economy became more pronounced, the trend of increase in risk appetite in global financial markets continued. Accordingly, as had been the case since the second half of 2009, emerging markets attracted more capital through increased portfolio movements. On the other hand, risk premium indicators in most developing countries remained below those of pre-crisis levels. In this period, Turkey’s risk premium indicators continued their positive trend and did not differentiate from the general trend except for short periods when developments specific to our country were pronounced (Figure 21).

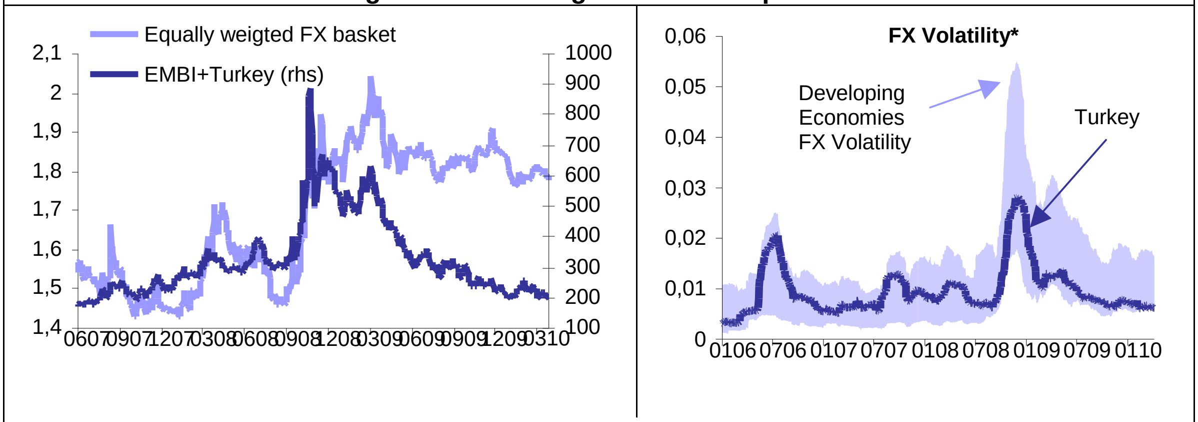
Figure 21: Risk Premium Indicators



Source: Bloomberg, CBT.

The improvement in global risk perceptions in the first quarter led the currency of many developing countries to appreciate. In terms of changes in currency values, the Turkish lira did not significantly differ from currencies of other emerging markets in this period and the relatively stable course of the Turkish lira in the crisis period continued throughout the post-crisis process as well (Figure 22).

Figure 22: Exchange Rate Developments

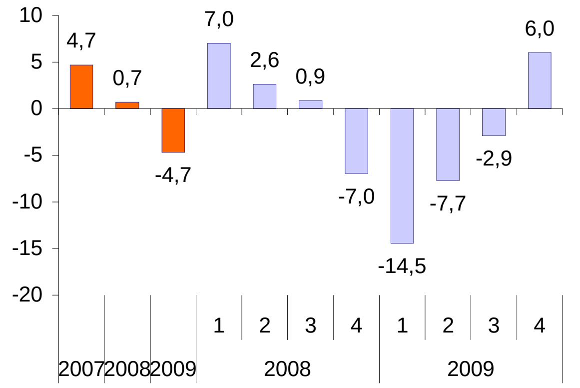


*Standard deviation of 50 days; Brazil, Chile, Czech Republic, Hungary, Mexico, New Zealand, Poland, S. Africa, S. Korea, Colombia, Turkey (maximum and minimum values).

Source: Bloomberg, CBT.

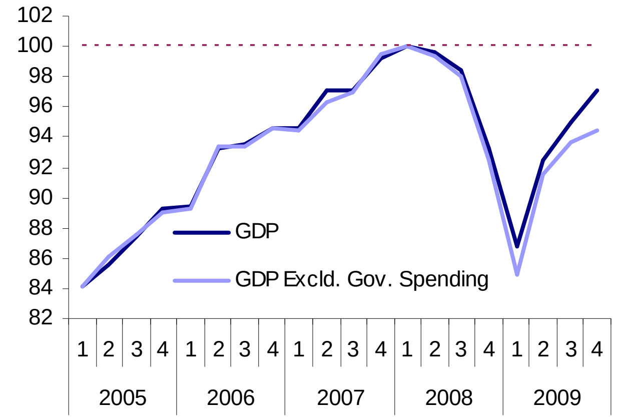
National income data of the last quarter of 2009 were consistent with the outlook we presented in the January Inflation Report. In this period, while the mild recovery in private sector demand continued, public sector consumption expenditures increased more than envisaged due to temporary factors. Meanwhile, persisting problems in the global economy restricted foreign demand, whereas stock accumulation started, albeit slowly, along with the improvement in domestic demand. In this regard, while the Gross Domestic Product increased by 6 percent on an annual basis in the last quarter of 2009, it decreased by 4.7 percent across the year (Figure 23). Seasonally adjusted data indicate continuance of the recovery process in national income as of the second quarter of 2009 (Figure 24).

Figure 23: Annual GDP Growth Rates by Periods
(Percent)



Source: TurkStat.

Figure 24: GDP
(Seasonally-adjusted,
2008 Q1=100)

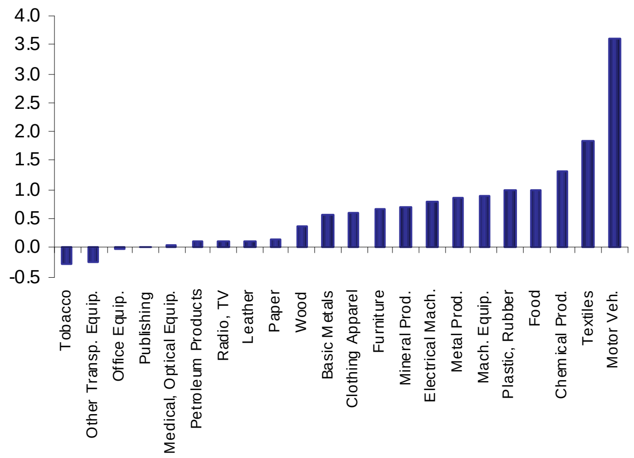


Source: TurkStat, CBT.

Data regarding the first quarter of 2010 indicate that the rebound in domestic demand is gradually becoming stable and broad-based. The influence of policy rate cuts besides the hikes in public expenditures are getting more pronounced and a relatively more robust activity in sectors sensitive to domestic demand is being witnessed. In this respect, the analysis of the recovery process in industrial production indicates that besides the sectors stimulated by fiscal incentives and their intermediate input suppliers as well as the non-durable goods sector and sectors with strong links to the construction sector have been on the rebound (Figure 25).

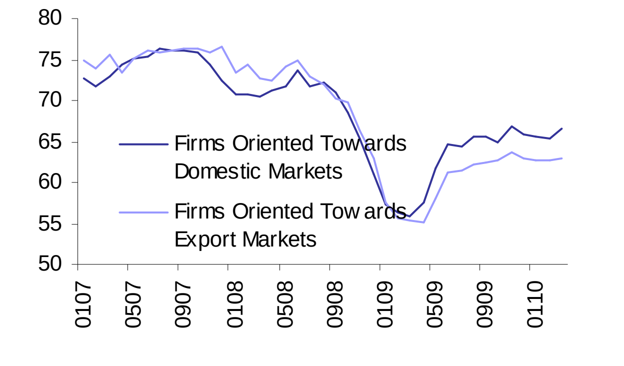
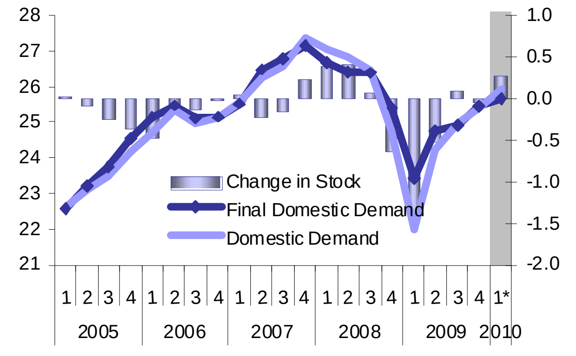
Figure 25: Cumulative Contribution to Industrial Production between March 2009 and February 2010

(Percentage Points)



Source: TurkStat, CBT.

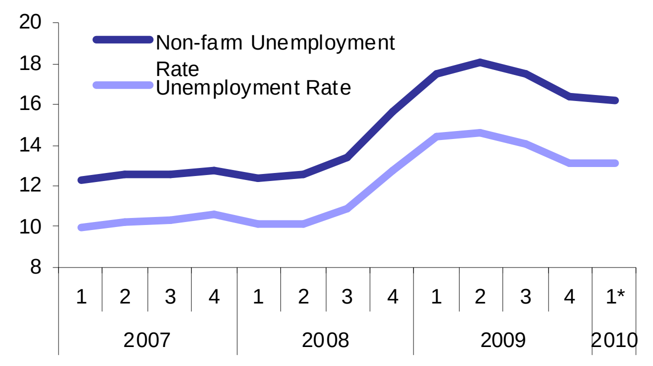
There is no significant improvement in external demand. The global growth outlook continues to dampen economic activity, particularly in sectors that are relatively more sensitive to foreign demand. Following the recent crisis, manufacturing firms that mostly serve external markets have been operating at lower capacity than local market oriented firms (Figure 26). Thus, in line with our previous forecasts, domestic demand has remained more robust than foreign demand. Yet, aggregate demand uncertainty continues to be a major concern, as inventory buildups have remained limited. Against this background, the gradual recovery in domestic demand is expected to continue into the first quarter (Figure 27). However, I would also like to emphasize that the achievement of a two-digit annual growth rate is highly probable in the first quarter of 2010 due to the low base of the same period last year.

Figure 26: Capacity Utilization in Manufacturing Industries (Percent)	**Figure 27: Final Domestic Demand** (Seasonally Adjusted, at 1998 Prices, Billion TL)
	
Source: CBT.	*Forecast Source: TurkStat, CBT.

The weak course of external demand continues to restrain economic activity and employment growth through its impact on industrial production. As a matter of fact, despite the recent partial recovery, indicators such as per capita hours worked across industries and capacity utilization rates of firms oriented towards export markets suggest that resource utilization remains low throughout the economy (Figure 26).

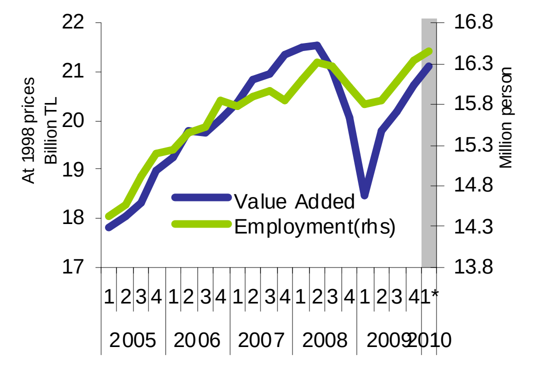
The recovery in the labor market that started in the third quarter of 2009 continued into the fourth quarter, albeit at a slower pace. Unemployment declined in seasonally adjusted terms, but still remains elevated (Figure 28). Given that ample slack would continue to be a drag on investment and employment, signs of improvement in employment data during the second half of 2009 are not expected to turn into a robust recovery, suggesting that the unemployment rate will likely remain elevated for an extended period. Therefore, unit labor costs would continue to support disinflation (Figure 29).

Figure 28: Unemployment Rates
(Seasonally Adjusted, Percent)



*As of January.
Source: TurkStat, CBT.

Figure 29: Value-Added and Employment in Non-Farm Sectors
(Seasonally Adjusted)

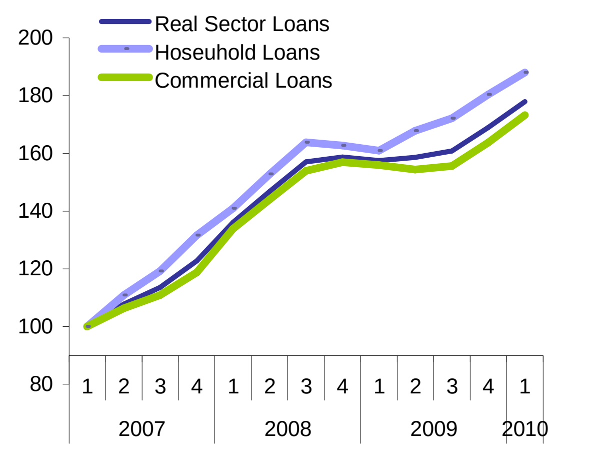


*Forecast.
Source: TurkStat, CBT.

Overall, recent data releases suggest that the economic recovery has become more robust. Domestic demand would continue to recover, while the weak outlook for global growth would dampen economic activity and employment in the tradable sector for sometime. Accordingly, we predict that aggregate demand conditions would not restrain inflation for a while. In this context, our revised medium-term forecasts are based on a disinflationary output gap—albeit narrower than envisaged in the previous Report.

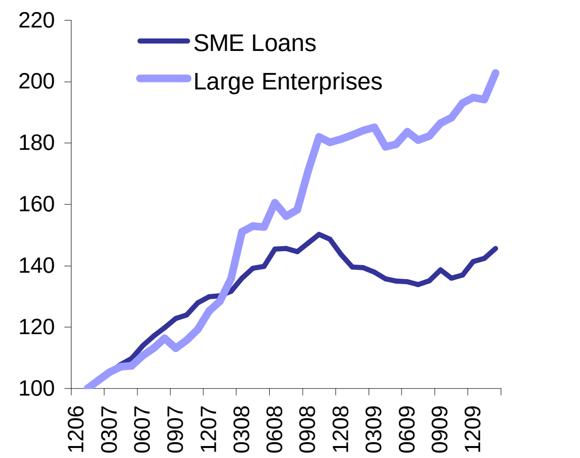
As I mentioned earlier in my speech, the tightness in credit conditions tend to attenuate with the effect of easing global liquidity conditions and improving risk appetites. The healthy state of the Turkish banking system is conducive for a rapid recovery in credit volumes. In fact, credit markets have been increasingly supportive of domestic activity in the recent period. Accordingly, the first quarter of 2010 was marked by the increasingly benign outlook for credit markets (Figure 30). Consumer loans have continued to recover while commercial loans have accelerated. Credit extended to small- and medium-sized enterprises has also begun to recover after a long period of stagnation, indicating the support of easy monetary conditions on economic activity (Figure 31).

Figure 30: Corporate Sector Loans / GDP*
(Percent)



* Corporate sector loans are composed of household loans and commercial loans.
Source: CBT.

Figure 31: Commercial Loans
(2007 January=100)



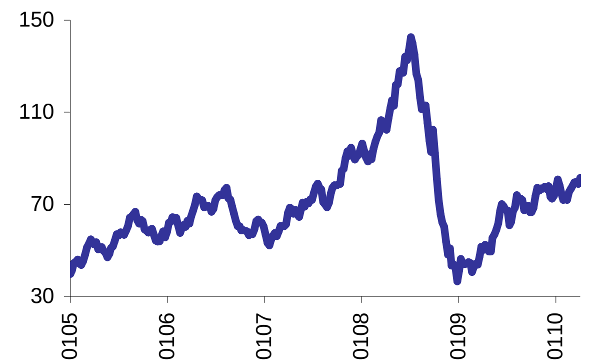
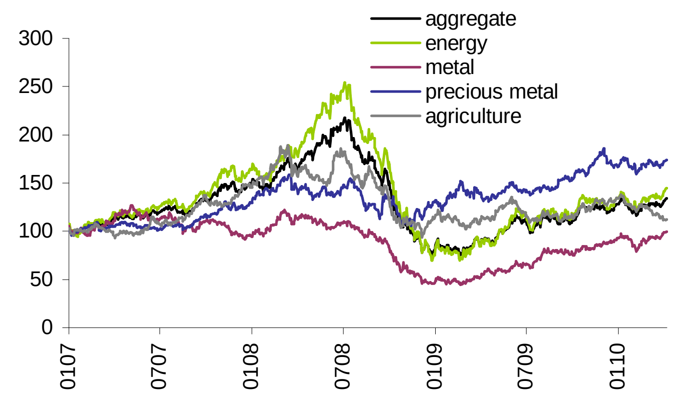
Source: CBT.

Assuming that external finance conditions continue to ease steadily and that the fiscal stance does not crowd out domestic funding, we expect that credit volumes would continue to expand in the forthcoming period. However, expectations that unemployment rates will remain at high levels for a long period, and ongoing problems in the global economy are still potential factors that might restrain credit expansion.

Although economic activity in the first quarter of 2010 has been broadly in line with the outlook presented in the January Inflation Report, there have been some developments, which necessitated an upward revision of the inflation forecast for 2010. As I believe that interpreting these developments accurately is very important, I would like to further elaborate on these developments.

First of all, the revisions to the Gross Domestic Product (GDP) series, and somewhat stronger-than-expected domestic demand have led to an upward revision in the output gap estimates, which have pushed the inflation forecast for end-2010 up by 0.4 percentage points (Table 2).

Considering recent developments, our oil price assumptions stated in the past Report have been revised slightly upwards (Figure 32). In this context, the previous assumption of oil prices are revised up from 80 USD per barrel to 85 USD for 2010, and from 85 USD to 90 USD for 2011 and thereafter (Table 2). Besides, in April, commodity prices surged to their highest levels for 2010 on the back of ongoing favorable growth expectations (Figure 33). Therefore, while producing medium-term forecasts, in line with oil prices, imported input costs are also assumed to increase gradually throughout the forecast horizon in response to the recovery in the world economy. This revision has shifted the 2010 inflation forecast up by 0.15 percentage points.

Figure 32: Crude Oil (Brent) Prices (USD/bbl)	**Figure 33: S&P Goldman Sachs Commodity Prices Indices ***
	
Source: Bloomberg.	* The average for January 2007 is indexed at 100. Source: Goldman Sachs.

The January Inflation Report envisaged food inflation to be 7 percent at end-2010, 6.5 percent for 2011 and 6 percent for the following years (Table 2). However, worse-than-expected outcomes regarding unprocessed food prices and ongoing supply-side structural problems led to an upward revision in the assumption for food inflation from 7 percent to 9 percent for 2010, which added 0.55 percentage points to end-2010 inflation forecast (Table 2). Similarly, assumptions for 2011 food inflation have been raised to 7 percent from 6.5 percent, and 7 percent from 6 percent for the following years (Table 2). At this point, I would like to highlight that the recent measures regarding meat prices posed a downside risk especially for our assumption on food prices in 2010.

In the previous Report, the impact of the tax measures implemented in January on fuel, alcohol, and tobacco products on 2010 inflation were estimated to be around 1.5 percentage points. However, the realization was 1.9 percent, partly reflecting the change in the weighting scheme of the CPI, and thus shifting the inflation forecast path by around 0.4 percentage points throughout 2010. Here I would like to particularly underline once more that the impact of the tax hikes would disappear at the beginning of 2011.

Table 2: Sources of Revisions to Inflation Forecasts

<table>
<tr><th></th><th colspan="4">January 2010 ER</th><th colspan="4">April 2010 ER</th></tr>
<tr><td>Output Gap</td><td colspan="4">2009 Q3:-8.1
2009 Q4:-7.3
2010 Q1: -5.8</td><td colspan="4">2009 Q3:-7.5
2009 Q4:-6.0
2010 Q1: -4.7</td></tr>
<tr><td>Oil prices</td><td colspan="4">2010: USD 80
2011 and onwards: USD 85</td><td colspan="4">2010: USD 85
2011 and onwards: USD 90</td></tr>
<tr><td>Food prices</td><td colspan="4">2010: %7
2011: %6.5
2012: %6</td><td colspan="4">2010: %9
2011: %7
2012: %7</td></tr>
<tr><td>Administered prices and taxes</td><td colspan="4">Adding 1.5 percentage points to 2010 inflation</td><td colspan="4">Adding 1.9 percentage points to 2010 inflation</td></tr>
<tr><td rowspan="3">Euro area growth forecasts[1]</td><td colspan="2">2010</td><td colspan="2">2011</td><td colspan="2">2010</td><td colspan="2">2011</td></tr>
<tr><td>CF</td><td>WEO</td><td>CF</td><td>WEO</td><td>CF</td><td>WEO</td><td>CF</td><td>WEO</td></tr>
<tr><td>1.3</td><td>0.3</td><td>1.6</td><td>1.3</td><td>1.2</td><td>1</td><td>1.5</td><td>1.5</td></tr>
</table>

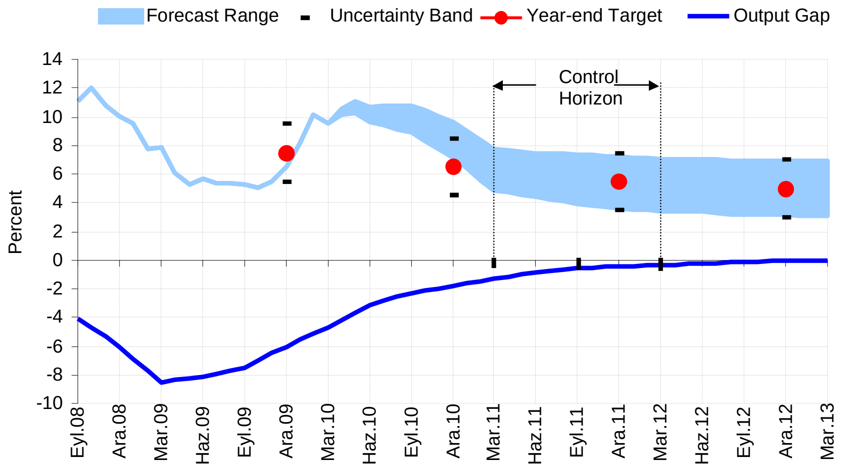
[1] Consensus Forecasts (CF) January 2010 and April 2010 (average annual growth, %); World Economic Outlook (WEO), October 2009 and April 2010.

Regarding fiscal policy, it is assumed that, in line with the Medium Term Program, the fiscal stance will remain expansionary—but less so than in 2009—throughout 2010, and that fiscal consolidation would gradually ensue starting from 2011 as guided by the fiscal rule set out in the Medium Term Program. In this respect, as implied by the fiscal rule, it is assumed that the fiscal space created by the stronger-than-expected economic activity leading to better-than-expected performance in budget revenues since the second half of 2009, would be used mostly to reduce the government debt stock; therefore, the goals set out in the MTP be implemented through institutional and structural improvements in 2011 and onwards. In other words, it is assumed that tax adjustments would be consistent with the inflation targets and automatic pricing mechanisms throughout the forecast horizon. Accordingly, it is envisaged that the rising debt-to-GDP ratios would gradually reverse course starting in 2011, and hence the risk premium would not display any significant changes throughout the forecast horizon.

Against this background, assuming that liquidity measures are normalized gradually over the short term and that policy rates are kept constant at current levels for some time followed by limited increases starting in the last quarter of 2010, with policy rates staying at single digits throughout the three-year forecast horizon, the medium-term forecasts suggest that, with 70 percent probability, inflation will be between 7.2 and

9.6 percent with a mid-point of 8.4 percent at end-2010, and between 3.6 and 7.2 percent with a mid-point of 5.4 percent by the end of 2011. Furthermore, inflation is expected to decline to 5.0 percent by the end of 2012 (Figure 34).

Figure 34: Inflation and Output Gap Forecasts*
(Percent)



- The shaded area indicates the 70 percent confidence interval for the forecast.

Despite the upward revision in the output gap, it is expected that the economic recovery would be gradual. However, owing to the effects of tax hikes, increases in food and energy prices, and base effects, the inflation rate is hovering significantly above the target, which is having an adverse impact on inflation expectations, and leading to risks regarding pricing behavior. Therefore, the revised forecasts are based on the assumption of gradually withdrawing the excessive amount of liquidity provided to the market, and increasing policy rates at a measured pace starting in the last quarter of 2010. However, based on the prediction that resource utilization will likely remain at low levels for sometime, the baseline scenario envisages that the increases in interest rates would be limited with policy rates remaining at single-digit levels throughout the forecast horizon.

As shown in the slide, inflation will follow a volatile path throughout 2010 owing to the base effects driven by the temporary tax cuts and unprocessed food price fluctuations that occurred during 2009 (Figure 34). The temporary tax cuts implemented in March 2009, which were withdrawn partly in June and fully in October, would cause headline inflation to increase during March and April, and to decrease during June, July and October of 2010. Accordingly, inflation is expected to increase slightly during the second quarter and then fluctuate at around 10 percent in the third quarter (Figure 34).

Inflation is expected to drop significantly in the last quarter of 2010 and the first quarter of 2011 (Figure 34). The fall in the last quarter of 2010 would reflect the base effects caused by the indirect tax hikes and the sharp increases in food prices that occurred during the last quarter of 2009. Similarly, the impact of the tax hikes, which added around 1.9 percentage points to headline inflation in the first quarter of 2010, would largely disappear during January and February of 2011. Accordingly, inflation would fall to 8.4 percent at end-2010, and display a significant drop during the first quarter of 2011, converging to levels consistent with the targets (Table 3). Afterwards, with the transmission of the lagged impact of the envisaged monetary tightening, inflation is expected to further decline and stabilize at around 5 percent over the medium term.

Table 3. CBT Inflation Expectations and Forecasts

	CBT Forecast	CBT Expectations Survey[1]	Inflation Target[2]
2010 Year-End	**8.4**	8.2	6.5
12 Month-Ahead	**6.3**	7.2	6.2
24 Month-Ahead	**5.2**	6.9	5.3

[1] Results from the second survey of April.
[2]Calculated by linear interpolation of 2010, 2011 and 2012 year-end inflation targets.
Source: CBT.

The projection that inflation would remain at elevated levels—albeit temporarily—over the forthcoming period, highlights the importance of expectations management. As of April, medium-term inflation expectations are significantly above the revised inflation forecasts (Table 3). In this respect, it is critical that economic agents, with an awareness of temporary factors, focus on medium-term inflation trends, and therefore, take the inflation targets as a benchmark for their pricing plans and contracts.

At this point, I would like to emphasize once more that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, I would like to particularly highlight that assumptions regarding future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBT.

4. Risks

In the last part of my presentation, I would like to talk about the risks with respect to the inflation outlook in the upcoming period and provide some information pertaining to the probable monetary policy strategy should these risks materialize.

The fact that inflation will remain elevated for some time warrants the close monitoring of price setting behavior. The combination of several unfavorable developments, such as unprocessed food and oil price increases, administered price hikes and base effects has led to a significant increase in inflation since the last quarter of 2009. Although these factors are temporary, they cause headline inflation to significantly exceed the inflation target, leading to an adverse impact on inflation expectations. Apart from items that are directly affected by cost push effects, current pricing behavior does not reveal any deterioration to the extent that might endanger the achievement of medium-term targets. However, I would like to remind you that monetary tightening may be implemented sooner than envisaged in the baseline scenario, should inflation expectations continue to rise and lead to a deterioration in general price setting behavior.

Although downside risks regarding global economic activity have been decreasing, they remain a concern. Rising budget deficits and ongoing problems in credit, real estate and labor markets across developed economies continue to pose downside risks for the recovery in global activity. Should the global conditions deteriorate again, and consequently delay domestic recovery, the policy rate may remain constant for a longer period than envisaged under the baseline scenario.

Uncertainties regarding the lagged effects of the strong monetary stimulus pose upside risks on both domestic and global economic activity. Given that the recovery in domestic demand has been relatively robust, a faster than- envisaged recovery in external demand could lead to a rapid narrowing in the idle capacity, which, coupled with cost push pressures, may delay the attainment of the medium-term inflation targets. In this respect, should the recovery in economic activity turn out to be faster than expected, the monetary tightening implied in the baseline scenario may be implemented sooner than envisaged.

Prospects regarding the pace of growth in developing economies, especially in China and India, have been posing upside risks regarding oil and other commodity prices. The increasing share of these economies in world demand has been creating additional pressures on commodity prices. I would like to emphasize that if commodity prices rise faster than expected in the forthcoming period and delay the disinflation, then we, as the Central Bank, may implement the monetary tightening described in the baseline scenario sooner than envisaged in order to eliminate the risks of deteriorating price setting behavior.

The Central Bank will continue to monitor fiscal policy developments closely while formulating monetary policy strategy. Since the second half of 2009, economic activity has been stronger than envisaged in the Medium Term Program, leading to a better-than expected performance in budget revenues. Using this fiscal room mostly to reduce the government debt, as implied by the fiscal rule, would enhance demand management and ease the need for indirect tax hikes, therefore providing more flexibility regarding the conduct of a stabilizing monetary policy. In this respect, we believe that should the goals set out in the Medium Term Program be implemented through institutional and structural improvements, such as enacting and establishing the fiscal rule, it would be possible to keep policy rates at single-digit levels over the medium term.

Since the last quarter of 2008, the CBT, without conflicting with its primary objective of price stability, has focused on containing the adverse effects of the global crisis on the domestic economy, which has, to a large extent, been achieved. Monetary policy will continue to focus on price stability in the period ahead. Adhering to the commitment for fiscal discipline and strengthening the structural reform agenda would support the improvement of Turkey's sovereign risk, and thus facilitate macroeconomic and price stability in the medium term. In this respect, while reiterating once more that timely implementation of the structural reforms envisaged by the Medium Term Program and the European Union accession process remains to be of the utmost importance, I would like to thank you for your participation.