CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2008-II

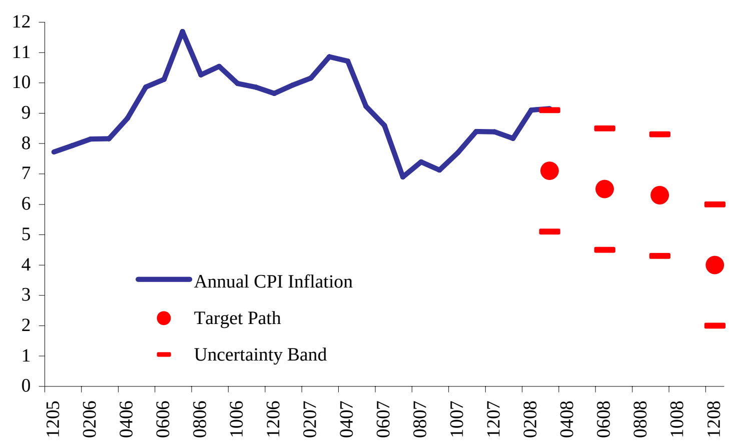
CONTENTS

1. Overview

1.1. Inflation Developments

Food, energy and other commodity prices continued to have adverse effects on inflation in the first quarter of 2008. Oil prices continued to rise and averaged around 100 USD per barrel. Annual food price inflation remained at elevated levels, reaching 13.4 percent in March. Moreover, rising financial volatility and declining risk appetite on the back of ongoing global uncertainties have led to exchange rate movements which had first round effects on March inflation. Consequently, inflation rose to 9.15 percent at the end of the first quarter, breaching the upper limit of the uncertainty band (Graph.1.1.1).

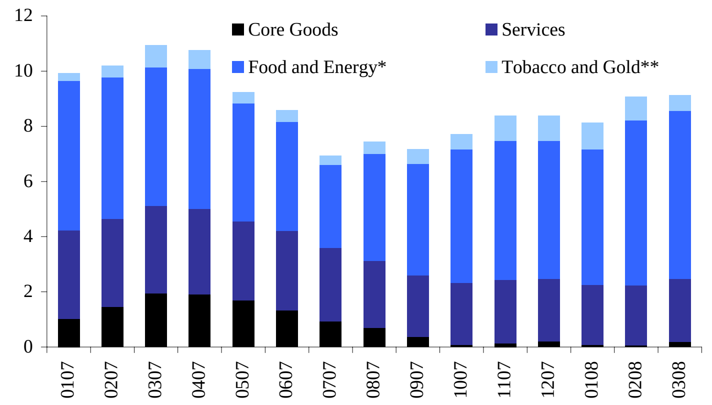
Graph 1.1.1. Annual CPI Inflation and Target Path



Source: TURKSTAT, CBRT.

As a consequence 6.13 percentage points of the 9.15 percent annual CPI inflation in March resulted from the food and energy items. Annual inflation in core goods and services remained flat over the previous quarter, confirming that the rise in inflation can be mostly attributed to factors beyond the control of the monetary policy (Graph 1.1.2). Annual inflation in CPI excluding food, energy and tobacco items was at 4.8 percent at the end of the first quarter.

Graph 1.1.2. Contribution to Annual CPI Inflation

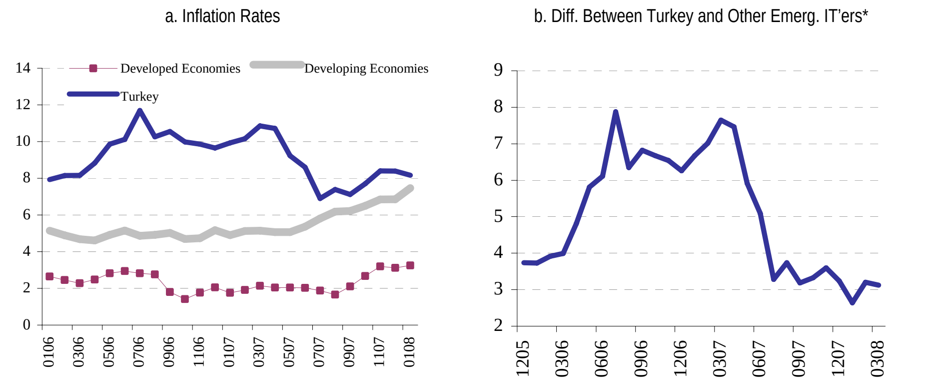


* Food and Energy: Food, non-alcoholic beverages and energy.
** Tobacco and Gold: Alcoholic beverages, tobacco products and gold.
Source: TURKSTAT, CBRT.

In September 2007, Monetary Policy Committee (MPC), referring to the deceleration in the core inflation indicators, decided to initiate the rate cuts which had already been signaled earlier in the year. Accordingly, policy rates were lowered by 225 basis points between September 2007 and February 2008. However, the food and energy prices and global uncertainties have continued to rise since then, feeding into inflation expectations and core prices and thus increasing the risks regarding the price setting behavior and the degree of inflation persistence. Consequently, the MPC decided to suspend the easing cycle at its March meeting and announced a clear tightening bias going forward at its April meeting.

Inflation has recently been rising all over the world. Elevated prices of crude oil, agricultural products and other commodities have continued to exert inflationary pressures. Inflation in developed economies edged up in the last quarter of 2007 while emerging economies under inflation targeting have been facing an upward trend since June 2007. Annual inflation in Turkey by the end of the first quarter was 9.2 percent, which is below its end-2006 level of 9.7 percent. During the same period, average inflation in emerging market economies under inflation targeting rose from 3.4 percent to 6.1 percent (Graph 1.1.3).

Graph 1.1.3. Inflation in Other Countries



*Sample of emerging economies under inflation targeting covers Brazil, Czech Republic, Colombia, Philippines, South Africa, Israel, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand.

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

1.2. Inflation Outlook and Monetary Policy

Current supply and demand conditions support the downward trend in inflation. Monetary tightening in mid-2006 have led to a widening in the output gap. The recent methodological change in national accounts led to a limited upward revision in our output gap measure and hence did not change the inflation outlook. Looking ahead, we expect a continued moderation in economic activity and non-farm employment on the back of rising precautionary saving due to global and domestic uncertainties. Accordingly, demand and capacity conditions are expected to continue to support the disinflation. Therefore, assuming that supply shocks gradually fade out over time, headline inflation is expected to decelerate.

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

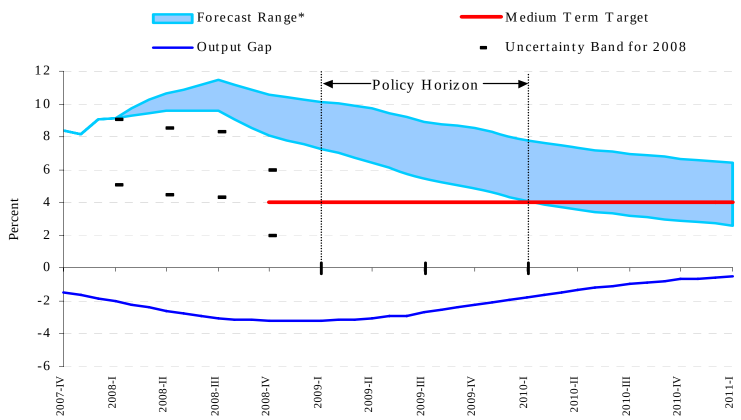
Our revised forecasts for medium term inflation incorporate more conservative assumptions on food prices compared to the January Inflation Report, which envisaged a correction in food inflation justified by more favorable weather conditions. However, the long-awaited correction in food prices has not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

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

The impact of recent movement in the exchange rates is likely to be significant in the short term. Although weak domestic demand should limit the second round effects of the exchange rate pass-through, the first round impact of the recent depreciation is estimated to be around 1.5 to 2-percentage points at the end of 2008, which implies an additional upward revision in our forecasts.

Accordingly, we now forecast inflation to be around 9.3 percent at the end of 2008. Our medium term forecasts suggest, with 70 percent probability that, under the assumption of a gradual and measured tightening towards mid-2008 and constant policy rates thereafter, inflation will be between 4.9 and 8.5 percent (mid point 6.7) at the end of 2009 (Graph 1.2.1). Assuming a gradual moderation in food inflation, headline inflation is expected to decelerate to 4.9 percent at the end of 2010 and to 4 percent by mid-2011. We expect non-food inflation to be lower than these figures.

Graph 1.2.1. Inflation Forecasts*



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

To sum up, supply shocks have turned out to be more persistent than expected, increasing the risks of second round effects and necessitating a significant upward revision in our inflation forecasts. Accordingly, monetary policy has already assumed a more cautious stance. Ensuring a steady decline in inflation will require tight monetary policy to be maintained for an extended period.

It should be emphasized that any new data or information on the inflation outlook may lead to a change in our policy stance. Therefore, the path for the policy rates indicated above should not be perceived as a commitment on behalf of the CBRT.

Our policy strategy is to tolerate the first round effects of supply shocks but to promptly respond to any deterioration in the overall pricing behavior. Bringing inflation back to 4 percent by the end of 2009 would require offsetting the first round effects of the likely supply shocks that are expected to continue during 2008-09, and thus create undesired fluctuations in the economic activity and relative prices. That is why our framework incorporates an inflation forecast significantly higher than 4 percent at the end of 2009.

1.3. Risks

Our revised forecasts are based on quite conservative assumptions, especially on food and energy prices, implying that downside risks are as significant as upside risks. Considering the role of supply shocks under current conditions, the last chapter of this Report also provides projections under alternative scenarios for food and energy prices: Our pessimistic scenario assumes food inflation to materialize at 17, 11 and 10 percent in the next three years, and oil prices to soar to 150 USD per barrel at the end of 2009. Under this scenario, assuming that policy rates increase gradually throughout the year 2008 and then stay constant for while, it takes four years for inflation to go back to 4 percent. Our optimistic scenario assumes that food inflation materializes at 9, 5 and 4 percent in the next three years, and oil prices eases to 85 USD per barrel at the end of 2009. Under this scenario, assuming a limited rate hike in the short term and gradual cuts starting from the last quarter, inflation reaches 4 percent at the end of 2010.

A protracted period of rising food and energy prices have led to a significant overshooting of the inflation targets since the adoption of the inflation targeting regime and consequently increased the stickiness in inflation expectations, as economic agents have become more backward looking. Under normal conditions, supply shocks are expected to alter relative prices rather than the underlying inflation trend. Nevertheless, the fact that several long-lasting shocks appeared concurrently has increased the risks to the price setting behavior. The recent pick up in inflation expectations therefore requires a monetary policy response. In this respect, recent developments in the pricing behavior and the underlying inflation trends are of particular concern. Therefore, it may be necessary to pursue a tighter monetary policy than that envisaged in our baseline should the price setting behavior deteriorate even further.

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

Finally, our medium-term projections assume no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanism. In particular, this means that any needed tightening in the fiscal balance would occur largely through expenditure cuts and not higher excise taxes. Any deviation from this may have an effect on the outlook for inflation and monetary policy.

1.4. Conclusion

Emerging risks on the food and energy prices suggest that converging to the 4 percent medium term inflation target may take a considerable amount of time. Besides, ongoing uncertainty resulting from the global economy has the potential to further restrain disinflation. Accordingly, the CBRT envisages a framework in which it takes more than two years to reach the 4 percent inflation target.

Extending the horizon within which inflation converges to the target does not mean that monetary policy will be looser in the forthcoming period. On the contrary, our inflation forecasts presented above are predicated on a gradual and measured tightening of monetary policy in the period ahead. Moreover, monetary policy will be more responsive to bad news than good news. This approach reflects our firm commitment to attaining price stability.

Prudent monetary policy is a necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical in the road to price stability. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance the productivity, are monitored closely by the 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 expanded by 2.5 percent in the fourth quarter of 2007 and by 2.2 percent for the year as a whole, and is expected to continue its growth slowdown in 2008. Financial institutions revised their growth estimates down due to ongoing concerns surrounding the US economy such as financial fragility, tight credit conditions, soaring prices for energy and other commodities and the deepening housing contraction. Indeed, the growth forecast for 2008 was cut from 2.0 percent, as stated in our January 2008 Inflation Report, to around 1.3 percent in April. In addition, the economy is forecast to grow at an annual rate of 2.3, 1.4, 0.8 and 1.2 percent, respectively, in each quarter of the year. Growth rates are not expected to be higher than 2 percent until the second quarter of 2009 (Table 2.1.1).

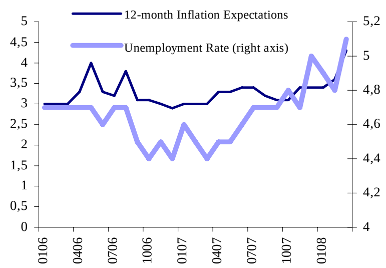
Table 2.1.1. Growth Rates
(Annual Percentage Change)

			2007		2008				2009	
	2007	**2008***	**III**	**IV**	**I**	**II***	**III***	**IV***	**I***	**II***
World	**4.9**	**3.7**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
USA	**2.2**	**1.3**	**2.8**	**2.5**	**2.4***	**1.4**	**0.8**	**1.2**	**1.7**	**2.4**
UK	**3.0**	**1.6**	**3.3**	**2.9**	**2.3***	**1.4**	**1.3**	**1.1**	**1.3**	**1.7**
Japan	**2.0**	**1.3**	**1.9**	**1.7**	**0.9***	**1.6**	**1.6**	**1.3**	**1.7**	**1.8**
China	**11.9**	**9.3**	**11.5**	**11.2**	**10.6**	**-**	**-**	**-**	**-**	**-**
Germany	**2.5**	**1.7**	**2.5**	**1.8**	**1.3***	**1.6**	**1.3**	**1.4**	**1.6**	**1.7**
France	**1.9**	**1.5**	**2.2**	**2.1**	**1.8***	**1.8**	**1.4**	**1.4**	**1.6**	**1.7**
Italy	**1.6***	**0.6**	**1.9**	**0.8***	**0.7***	**0.9**	**0.7**	**1.0**	**1.1**	**1.3**

*Forecast.
Source: Consensus Forecasts, IMF World Economic Outlook, National Bureau of Statistics of China.

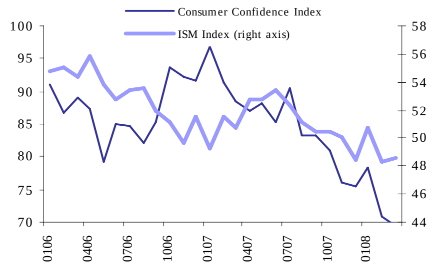
Spillovers from the reduced labor demand in sectors such as housing, in particular, manufacturing, construction and retail trade to the broader economy were evident by the deterioration of inflation expectations, the sharply rising unemployment rate and the still-dropping University of Michigan Consumer Confidence Index and ISM Index (Graph 2.1.1, Graph 2.1.2).

Graph 2.1.1. US Unemployment Rate and Expectations
(Percent)



Source: Bloomberg, Institute for Supply Management.

Graph 2.1.2. University of Michigan Consumer Confidence Index and ISM Index

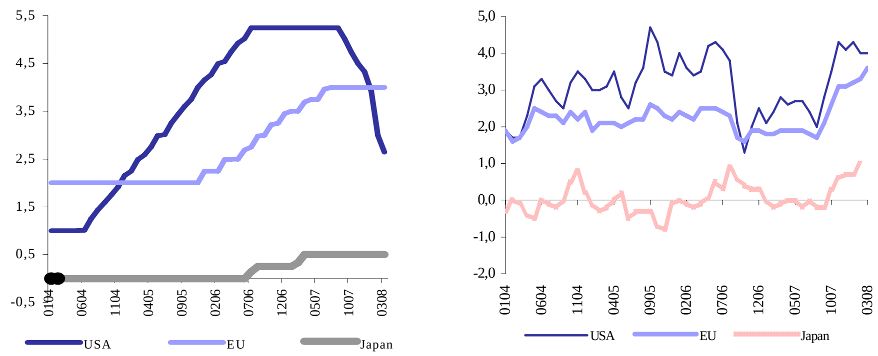


Source: Bureau of Labor Statistics, University of Michigan.

Amid concerns over a slowing economy and worsened financial market conditions (particularly housing), the Federal Reserve (Fed) has, despite fears of inflation, cut the federal funds rate by a cumulative 225 basis points since September to 2.25 percent (Graph 2.1.3, Graph 2.1.4). Moreover, to bolster liquidity and promote orderly functioning in financial markets, the Fed continued to conduct the Term Auction Facility (TAF) that was set up in December 2007, auctioning 120 billion US dollars in January and February. Yet, the Fed announced that the amounts outstanding in TAF auctions would be increased to 100 billion US dollars per month by March, and that it would initiate a series of term repurchase transactions to address heightened liquidity pressures in financial markets.

Graph 2.1.3. Federal Funds Rate*
(Percent, Monthly Average)

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



Source: Bloomberg.

Source: Bloomberg.

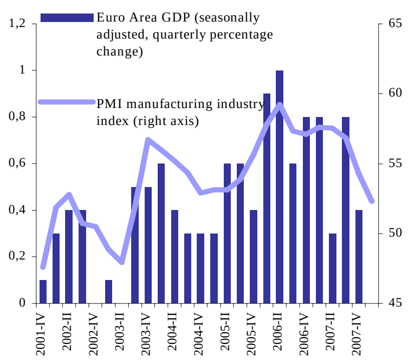
The Federal Reserve announced on March 11 that it would expand its securities lending program and establish a Term Securities Lending Facility (TSLF) that would offer loans to primary dealers secured for a term of 28 days (rather than overnight, as in the former program). Under the new TSLF, the Fed plans to lend up to 200 billion US dollars to primary dealers through weekly auctions that started on March 27. In addition, the Fed also announced on the same date that it authorized increases in its existing temporary reciprocal currency arrangements (swap lines) with the European Central Bank (ECB) and the Swiss National Bank (SNB) and extended the term of these swap lines through September 30, 2008. Lastly, the bank announced on March 16 that it established a Primary Dealer Credit Facility (PDCF) intended to improve the ability of primary dealers to provide financing to participants in securitization markets.

US exports have been on a marked uptrend, providing a boost to the economy and an offset to the current account deficit. US exports have been buoyed by several factors, including the solid growth in major US trading partners, the limited spillover from global financial woes into those countries, and the continued depreciation of the US dollar.

Euro area GDP grew by 2.6 percent in 2007 despite a relatively weaker fourth quarter. Thus, the euro area growth in 2007 came in higher than the 10-year average of 2.2 percent. As higher food and energy prices crimped household spending, the rate of growth of private consumption, a major component of GDP, slowed down in the final quarter, contributing less to the economy. Investments, on the other hand, climbed on higher profitability, rising capacity utilization and relaxed credit conditions, and became a main determinant of growth. Another driver of GDP growth has been net exports despite the strengthening of the euro vis-à-vis the dollar over 2007.

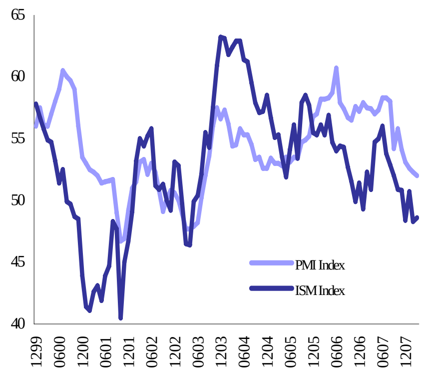
Potential downside risks to the outlook for euro area growth in 2008 include internal, external and financial risks. Strong labor markets, an unemployment rate at a 25-year low and the easing of credit conditions that tightened after the financial crisis in May 2006 help alleviate internal risks to euro area growth. Moreover, the fact that euro area industrial production was up 3.3 and 3.1 percent in January and February, respectively, led by the expansions in Germany and France, confirms that internal risks have subsided recently. Yet, the increased likelihood of a US recession as well as the uncertainties surrounding crude oil, food and base metal prices raise external risks to euro area growth. Besides, as the Institute for Supply Management's manufacturing index (ISM) from US fell below 50 into contraction territory and the unemployment rate has inched higher, many believe that the EU economy may not grow as briskly as in 2007. Likewise, the euro area manufacturing industry confidence index (PMI) appears to confirm that view (Graph 2.1.5, Graph 2.1.6). The impending US recession is expected to cause particular damage to the European economy through foreign trade and financial markets. Still, since total euro area exports remain robust and the US share in total exports has dropped over the past few years, fears of a likely spillover from a potential US recession into euro zone through the foreign trade channel started to fade (Graph 2.1.7). However, as concerns over the US sub-prime crisis have mounted, losses at European commercial banks that invest heavily in mortgage-backed securities became highly evident in the recent period. Given the fact that euro area companies rely mainly on commercial banks to finance their business, the currently improved credit conditions might deteriorate in the upcoming period, weighing on investment and consumer spending. On balance, the US economic downturn is likely to curb euro area growth through the financial sector, rather than the foreign trade channel, in the short term.

Graph 2.1.5. Euro Area GDP and PMI Index



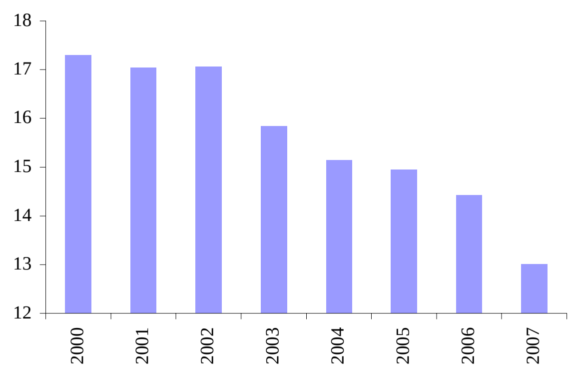
Source: Bloomberg, Eurostat.

Graph 2.1.6. ISM and PMI Indexes



Source: Bloomberg.

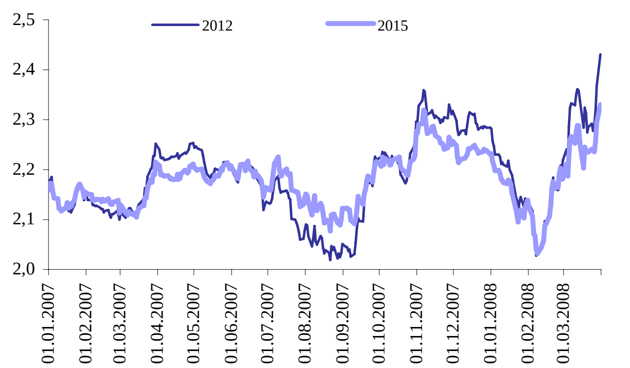
Graph 2.1.7. US Share in Total Euro Area Exports



Source: Eurostat.

The euro area Harmonized Index of Consumer Prices (HICP) inflation surged to historic highs in February and March 2008, confirming the ongoing strong upward pressure on price stability. The larger-than-expected money and credit growth, in particular, and higher energy and food prices continue to pose upside risks to the inflation outlook for 2008. Another key factor to consider is that the euro area core inflation, as measured by the HICP excluding energy and food, exceeded the 2-percent target in the first quarter of 2008 after having remained under 2 percent in 2007. The fact that core inflation amounted to 2.7 percent in March will also have an adverse impact on price developments in 2008. Moreover, the spread between yields on French government bonds and euro area inflation-linked government bonds with the same maturities, which serves as an indicator of inflation expectations for the euro area, has recently remained above the threshold, pointing to a deterioration in medium to longer-term inflation expectations (Graph 2.1.8).

Graph 2.1.8. Euro Area Inflation Forecast*
(Percent)



* Measured by the spread between yields on French government bonds and euro area inflation-linked government bonds.
Source: Agence France Trésor.

Against this backdrop, the ECB Governing Council decided unanimously at its meeting in April to leave the key ECB interest rates unchanged. The ECB noted the prevailing upside risks to price stability in a more forceful tone than the previous months, but emphasized that the uncertainty resulting from the turmoil in financial markets poses a greater risk to euro area growth. The ECB also added that they expect the inflation to moderate by mid-2008 but remain above the 2-percent target over 2008. Besides, as the unemployment rate has fallen to a record low and the demand for higher wages has grown among German workers, concerns over second-round effects of rising food and energy prices on inflation have intensified over the previous quarter. In view of these considerations, the ECB indicated that they will act preemptively to avoid second-round effects on price stability.

Like the rest of the world, Japan’s economy has slowed on higher energy and commodity prices. The Japanese economy grew at an annual rate of 2.4 and 2 percent, respectively, in 2006 and 2007 (Table 2.1.1). The 1.7 percent rise in the fourth quarter of 2007 had been beyond expectations, mainly as private investments were up 2 percent. Private investments had grown strong enough to offset the continued slowdown in private consumer spending (by 1.5 percent) and in housing starts (by 1.1 percent). During the first quarter of 2008, as markets were hampered by concerns over worsening corporate profits amid higher energy prices and rising yen, the rate of increase in fixed capital investments slowed. Against this background, the Japanese economy is expected to grow by 0.9 percent in the first quarter of 2008.

Consumer prices in Japan were stable over 2007, but since the turn of 2008, they have been rising at a modest pace in response to the surge in world commodity prices. Accordingly, consumer prices rose at an annual rate of 0.7 and 1 percent in January and February, respectively. This trend is expected to continue into the upcoming period along with the rise in oil and food prices (Graph 2.1.4). Besides, the index for wholesale commodity prices increased 3.9 percent in March and hit a 27-year high.

The Bank of Japan (BoJ) indicated that the leveling-off of neither private consumer spending nor public and housing investments will have a significant impact on domestic demand. The bank also noted that external demand will not display an abrupt decline as world economies continue to expand at subdued rates despite global uncertainties. In view of these considerations, the BoJ decided to leave its overnight call rate at 0.5 percent (Graph 2.1.3). Moreover, the bank emphasized that the uncertainties surrounding global financial markets and the continued acceleration in oil and commodity prices put pressure on the Japanese economy.

China's economy continued to expand rapidly in 2007, with an annual growth rate of 11.9 percent. Apparently, the US downturn did not hurt the Chinese economy as severely as expected, mainly because China's foreign trade shifted towards India, in particular, and Russia, Europe and Asia in 2007. That year, Chinese exports increased by 25.7 percent. Yet, as the overheated economy did not cool off sufficiently, the upward pressure on commodity prices persists.

Fixed capital investments in China yielded lower returns, resulting in supply-side constraints, while the excess liquidity in financial markets created an excess demand, leading to a 4.8 percent rise in consumer prices. After having increased by 4.4 percent in 2007, prices for intermediate goods, fuel and electricity are expected to remain on an upward trend over the coming periods and exert further upward pressure on prices in general. In fact, consumer prices rose by 7.1 and 8.7 percent, respectively, in January and February 2008. It is remarkable that China's consumer price inflation coincides with global price hikes.

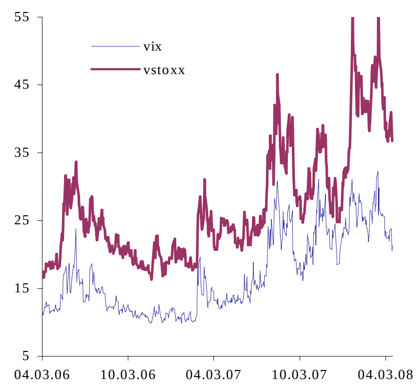
In reference to the sharp upturn in consumer prices and the uncertainties surrounding international housing markets, the People's Bank of China (PBC) decided to shift its monetary policy from prudent to tight in 2008 and not only raised the benchmark interest rate (by 4.14 percent) but also lifted the reserve requirement for the second time in the first quarter of 2008. The bank also decided to move towards adopting a floating exchange rate regime.

2.2. International Markets

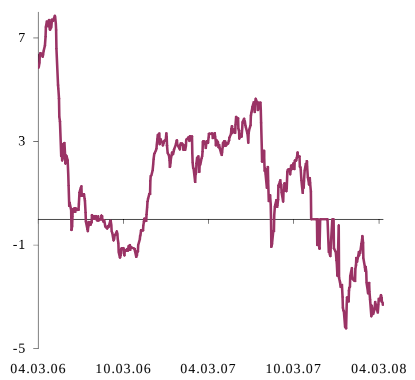
2.2.1. Financial Markets

The impact of the credit crisis that hit financial markets in the second half of 2007 was felt broadly in the real economy during the previous quarter. Commercial banks and investment banks have announced, one after another, multibillion-dollar losses over the recent months, and investors have become increasingly sensitive to any changes in the investment climate amid bad news concerning the US macroeconomic outlook and mounting concerns about the severity of the impending US recession. On balance, investors' appetite for risk has waned, causing a rise in volatility in emerging markets.

Graph 2.2.1. VIX and VSTOXX Indexes*



Graph 2.2.2. Credit Suisse Global Risk Appetite Index



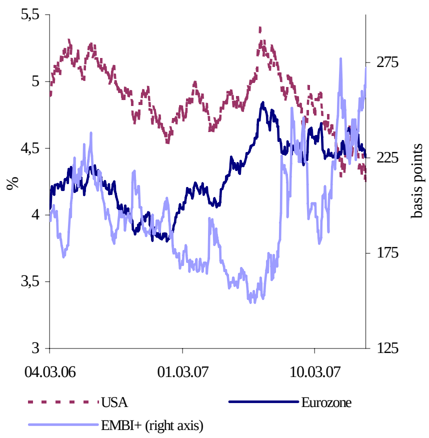
*The VIX volatility index is based on S&P500 options, while the VSTOXX is based on Dow Jones Euro Stoxx 50 options.
Source: Bloomberg.

Source: Credit Suisse.

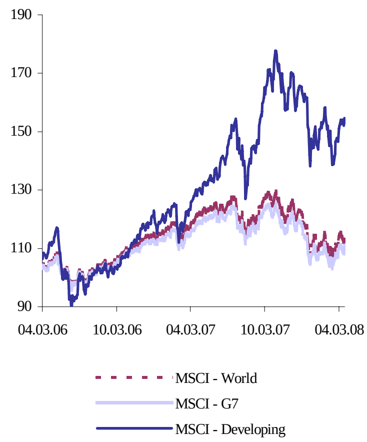
Indicating a sharp dip in the global risk appetite level, the Credit Suisse Global Risk Appetite index (CSRA) entered the panic zone, the lowest since October 2002[1]. VIX and VSTOXX indexes, on the other hand, have been on the decline for the past few days after having remained on an upward track throughout 2007; yet, they have already exceeded their 5-year average and signaled a reduced appetite for risk, though not as sharp as the CSRA index (Graph 2.2.1, Graph 2.2.2).

As regards bond markets in developed economies, the first thing to note is the continued decline in long-term US Treasury bond yields resulting from both the impending US recession and the rush for safe havens. Unlike US bonds, Eurozone bond yields remained relatively flat since the ECB maintained its tightening policy to stave off inflation and the euro area inflation remained on an upward trend. On the emerging markets front, however, the EMBI+ index widened to some extent during the first quarter of 2008 mainly on the back of falling US bond yields (Graph 2.2.3). Yet, the EMBI+ Turkey sub-index performed poorly in the first quarter, trading at a spread of 40 basis points over the main EMBI+ (the spread had narrowed to 1 basis point at end-January 2008).

Graph 2.2.3. Government Bond Markets



Graph 2.2.4. Equity Markets



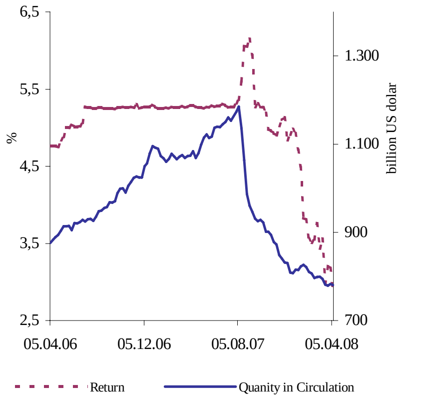
Source: Bloomberg.

The upward trend in stock markets reversed in the fourth quarter of 2007. On April 16, 2008, the Morgan Stanley (MSCI) G7 Index was down 6.3 percent from end-2007 and 9.1 percent from the third quarter of 2007.

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

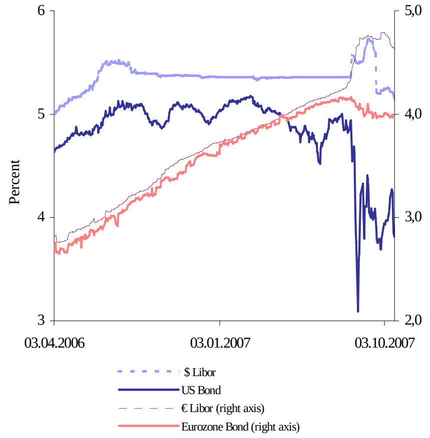
Likewise, the MSCI Emerging Markets Index (EMI) was down 6.5 and 3.3 percent, respectively, in dollar terms (Graph 2.2.4).

Graph 2.2.5. Developments in the US Asset-Backed Commercial Paper Market



Source: Bloomberg, Fed.

Graph 2.2.6. US and Euro Area Interbank Rates and Treasury Bill Yields (3-month)



Source: Bloomberg.

The Asset-Backed Commercial Paper (ABCP) Market, a valuable source of liquidity for investment banks, has significantly shrunk due to the uncertainty provoked by the US subprime mortgage crisis. After surging to a record 1.2 trillion US dollars in the first week of August 2007, bonds started to plunge in value and ended April 9, 2008 at 780 billion US dollars (Graph 2.2.5). Interbank rates surged to record highs on the ABCP market disruption and the liquidity squeeze in money markets. In fact, the spread between LIBOR rates and US treasury bond yields widened to over 200 basis points in dollar terms in mid-December 2007, and was back on a downward track, though by no means strong, following the coordinated liquidity injections by major central banks. The euro commercial paper market has shown similarities 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).

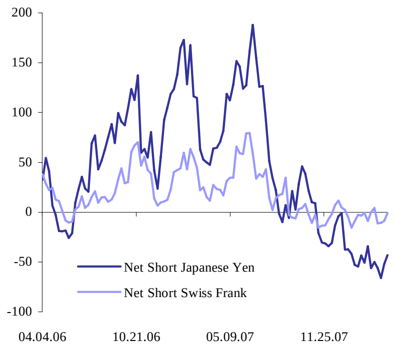
As suggested by the futures markets, both US dollar and euro interest rates are expected to decline in 2008. Considering the spot-futures spread, investors believe that both Fed's and ECB' rate cuts will total 50 basis points by the end of the year (Table 2.2.1).

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

	2008				
		Futures			
	Spot	**June**	**September**	**December**	**March**
US Dollar	3.00	2.46	2.25	2.33	2.33
Euro	4.75	4.63	4.33	4.10	3.82

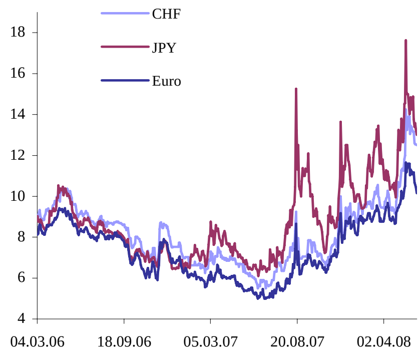
* 3-month futures contracts, as of April 16th. For US dollar, spot rates are taken from Eurodollar market, while futures rates are CME Eurodollar futures rates. For the Euro-zone, spot rates are taken from Euribor market, while futures rates are LIFFE futures rates.
Source: Bloomberg.

Graph 2.2.7. Net Short Positions in Japanese Yen and Swiss Franc (Non-Commercial Investors, Chicago Board of Trade)



Source: Bloomberg.

Graph 2.2.8. Implied Volatility for Yen/Swiss Franc/Euro vs. US Dollar Options



Source: Bloomberg.

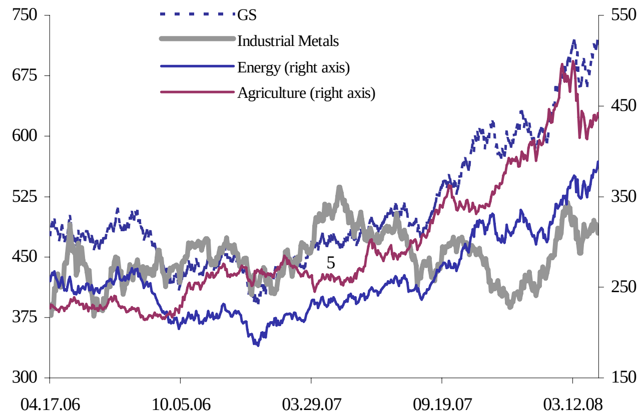
Available data for the future carry trade activity, currently an important source of liquidity for investors, indicate that speculators shift to long Japanese yen positions but go neutral in Swiss franc positions in view of recent developments in financial markets (Graph 2.2.7). The upward trend in implied volatilities that started in mid-2007 makes carry trade, particularly with the Japanese yen, riskier. The trend of both currencies points to a decrease in the carry trade activity of the previous quarter. Besides, given the strengthening of major currencies against the US dollar, carry trade may not recover, at least in the short run.

2.2.2. Commodity Markets

During the first quarter of 2008, the S&P Goldman Sachs (GS) Commodity Index continued to be on the rise, up 49.8 and 10.4 percent, respectively, from a year and a quarter ago. The index followed the same pattern in the first half of April, increasing 49.3 percent from the comparable period in 2007. The GS Energy, Agriculture and Metals indexes accounted for

6.9, 3.0 and 0.3 percent, respectively, of the quarterly growth rate of 10.4 percent during January-March 2008 (Graph 2.2.9).

Graph 2.2.9. S&P Goldman Sachs Commodity Indexes



Source: Goldman Sachs.

The GSCI Industrial Metals index made up 7.3 percent of the total GSCI index, with copper and aluminum together accounting for a substantial 5.5 percent share in the sub-index. The quarterly increase in prices of those two base metals traded on the London Metal Exchange (LME) was higher than their annual increase (Table 2.2.2). Based on a basket of 1 euro and 1 US dollar, instead of just the US dollar that has dropped sharply against other major currencies, the quarterly growth rates of aluminum and copper were down from 24.1 to 19.3 percent, and from 25.1 to 20.8 percent, respectively. The brisk demand from developing countries has already driven metal prices up, but the production cuts in Chile, world's largest exporter of copper, have led to a decline in copper inventories, thus raising the prices further. Moreover, despite a strong inventory performance (Table 2.2.3), aluminum prices have moved higher following the news that China will shift to a net importer of aluminum in 2008. Future prices of base metals will depend largely on the extent to which the possible US recession will impact on emerging economies.

Table 2.2.2. London Metal Exchange (LME) *

USD /MT	Value				Change (Percent)		
	2007-I	2007-IV	2008-I	2008-II**	2008-I/2007-IV	2008-I/2007-I	2008-II**/2008-I
Aluminum	2,780	2,409	2,990	2,999	*24.1*	*7.6*	*0.3*
Copper	6,755	6,675	8,390	8,430	*25.7*	*22.3*	*0.5*

* End-of-period values.
** As of April 15, 2008.
Source: Bloomberg.

Table 2.2.3. Base Metal LME Stock Levels*

	2006	2007			2008			
	Average	September	December	*Average*	January	February	March	April**
Aluminum	781,241	938,625	930,025	841,948	956,625	947,225	1,032,100	1,029,275
Copper	106,004	130,775	197,450	158,515	178,875	143,650	112,500	117,150

* LME stock levels for base metals are in metric tons.
** As of April 15, 2008.
Source : Bloomberg.

International crude oil prices, which has been surging since end-January, hit a new record at 114.5 US dollar per barrel on April 15 (Graph 2.2.10), up 67.3 percent from the same day in 2007. Yet, based on a basket of 1 euro and 1 US dollar, the rate of increase falls to 55.4 percent. As reported by the International Energy Agency (IEA), the demand for oil was up by 0.8 mbbl/d in 2007; but on a country-by-country basis, the demand for oil in non-OECD countries increased by 1.15 mbbl/d, while that in OECD members fell by 0.25 mbbl/d. The first-quarter rise in crude oil prices suggests that the demand remains strong, and the forecast by the US Department of Energy that US oil demand has reduced by an annual 0.48 mbbl/d highlights the significance of the demand from developing countries. The fact that OPEC left output quotas unchanged at its regular meeting on March 5 and announced it had no plans to hold an emergency meeting prior to its next regular meeting in September added to the pressure on prices. OPEC insisted that crude oil supplies were plentiful and indicators seemed promising, but claimed that speculative capitals were a key factor behind the upsurge in oil prices. On the supply front, a major variable influencing commodity prices, IEA reported that OECD industry stocks covered 53.3 days of forward demand in February, equaling the 3-year average. The US data, on the other hand, indicate that figures for March 2007 and March 2008 are alike. As crude oil forward curves stay in backwardation[2], crack spreads[3] remain very low and crude prices climb to a new peak, producers may become naturally less willing to build inventories (Table 2.2.4). Having said that, investors seem to react sharply to the reductions in weekly US inventory figures.

Table 2.2.4. Crude Oil Market*

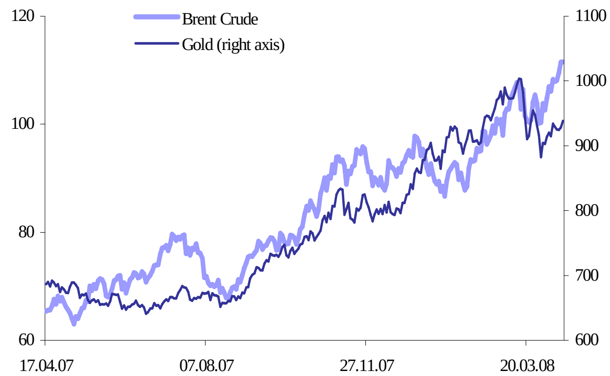
	2006	2007		2008			
	December	March	December	January	February	March	April**
Total Stocks (thousand barrels)	1,712.5	1,670.8	1,671.0	1,669.5	1,674.8	1,674.5	1,667.5
Products	704.2	649.4	685	678.4	670.7	655.6	651.0
SPR	688.6	688.7	696.4	698.1	698.7	699.75	700.4
Crude Oil	319.7	332.7	289.6	293.0	305.5	319.2	316.1
Crack Spread (USD/bbl)	6.8	20.6	8.6	7.3	10.3	8.8	7.2
Non-Commercial Net Long Positions (thousand contracts)	19.9	40.2	52.9	29.8	91.6	53.9	64.7

*End-of-period values. Stock figures are from the US. Net positions are NYMEX figures.
** Stock figures as of April 4, crack spread as of April 15, net positions as of April 8.
Source: Bloomberg, www.doe.gov.

[2] Futures prices fall as the contract approaches maturity.
[3] Contract based on the price differential between crude oil and petroleum products.

As the demand for crude oil is due to begin a seasonal decline in the second quarter, prices are expected to come down a little. Yet, the demand from developing countries remains a major concern for crude oil prices, and the fact that the US Department of Energy expects the US demand, which declined annually in the first quarter, to revert back to 2007 levels in the second quarter will strengthen the demand pressure. In other words, the uncertainties over the US economy and over the extent to which other economies will be able to escape the US slowdown continue to be the greatest risk to crude oil prices. Although producers find that unappealing, a buildup in inventories prior to the summer season when demand for oil is high will be a key factor to help ease the pressure on crude oil prices. Besides, the pressure on prices will further abate if financial investors see current oil prices as unsustainable and seek new investment opportunities.

Graph 2.2.10. Crude Oil (Brent) and Gold Prices
(USD/bbl, USD/oz)



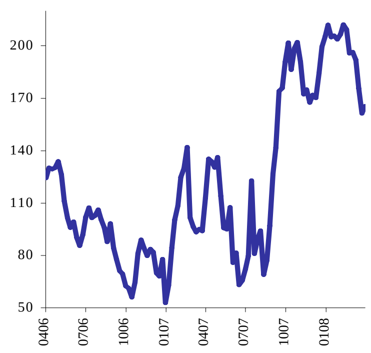
Source: Bloomberg.

The ongoing turbulence in developed markets, their higher inflation rates and clouded growth outlook, and the recent slump in the US dollar drove gold prices to a historic high of USD 1002 per troy ounce on March 14 (Graph 2.2.10). Although they decreased afterwards, gold prices ended April 15 at USD 928 per troy ounce, up 34.4 percent from the same day in 2007. Besides, the marked rise in net long positions of non-commercial investors since August 2007 hit an all-time high in February 2008. Though having retreated from their peak, speculators' net long positions still remain elevated (Graph 2.2.11).

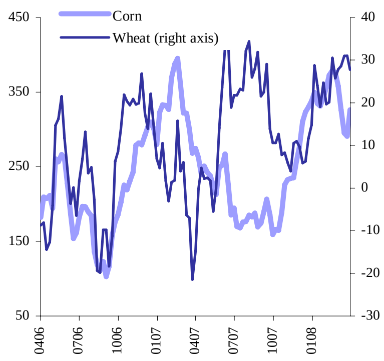
Further sharp increases in global food prices have a dominant role in boosting inflation in both developed and developing countries (Box 2.1). With a 8.2 percent share, corn and wheat are major components of the S&P Goldman

Sachs Agricultural Raw Materials Index that accounts for 12.9 percent of the total index. By April 15, the S&P Goldman Sachs wheat and corn indexes were up at an annual rate of 87.7 and 64.5 percent, respectively. Drought-related crop losses and ethanol production push corn and wheat prices up, while the fall in global corn and wheat stockpiles prompts speculators to invest in corn and wheat futures, putting further upward pressure on prices. Accordingly, speculative net-long positions in Chicago wheat and corn futures have increased dramatically (Graph 2.2.12). The downtrend in wheat prices since the first week of March, in anticipation of better harvest in the second half of 2008, has intensified as the US Department of Agriculture announced in its World Agricultural Supply and Demand Estimates (WASDE) report that global wheat stocks have increased.

Graph 2.2.11. Chicago Board of Trade Non-Commercial Net Long Positions
(Gold, thousand contracts)



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



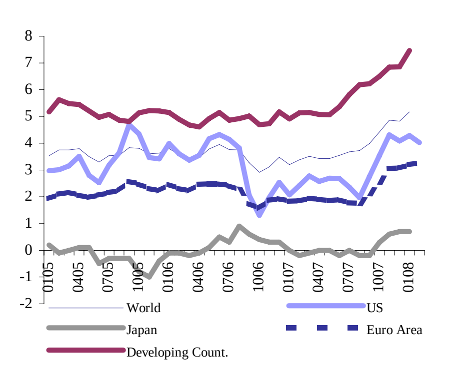
Source: Bloomberg.

The first quarter of 2008 was also notable for skyrocketing rice prices. By April 17, “B” quality Thai rice, a global benchmark, has increased by 164 percent since January 1. The growing demand from China and India as well as production cuts in Australia and Vietnam put pressure on rice prices. In emerging Asia, for whom rice is the most basic food item, governments have banned exports of rice in an effort to stabilize domestic prices against an acceleration, which, in turn, has strengthened the upward trend in international prices. Therefore, price hikes will solely affect importers of rice, as only 7 percent of total rice production is subject to foreign trade.

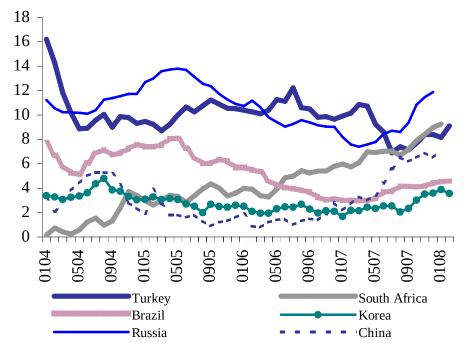
BOX 2.1. RECENT DEVELOPMENTS IN GLOBAL INFLATION

The recent changes in international prices indicate that inflation is generally on the rise. As reported by IMF, the global annual inflation rate was down to 3.5 percent in 2006 from 4.4 percent in early 2000 but started to rise again in mid-2007, ending January 2008 at 5.2 percent. The upward movement in global inflation is observed simultaneously in both developed and emerging markets (Graphs 1 and 2). Inflation rates in the US, EU, Japan and developing countries have shown similar patterns although their growth cycles might differ from each other. Therefore, the future direction of global inflation and the relationship between inter-regional and international inflation developments and global inflation come up as main discussion points.

Graph 1. CPI in Selected Countries



Graph 2. CPI in Selected Emerging Economies



Source: IMF

Circumstances of the world economy in early 2000s was rather different from what we observe today. Global economic conditions had then contributed to the disinflation process in many countries, including Turkey. Benefiting from the savings glut, the world economy had expanded without triggering inflation, while the integration of emerging economies like China and India into the world economy supported global disinflation through cheaper imported goods.[1] Lower energy prices, as compared to current levels, had restricted supply-side pressures on inflation.

Table 1. US, Japanese and Euro Area CPI and CPI Excluding Energy and Food

	US		Japan		Euro Area	
	All Items	Excluding Energy and Food	All Items	Excluding Energy and Food	All Items	Excluding Energy and Food
2004	3.3	2.2	0.2	-0.7	2.4	1.9
2005	3.6	2.2	-0.1	-0.4	2.2	1.4
2006	2.6	2.6	0.3	-0.3	1.9	1.5
2007 June	2.6	2.2	-0.2	-0.4	1.9	1.9
2007 December	4.1	2.4	0.7	-0.1	3.1	1.9
2008 January	4.3	2.5	0.7	-0.1	3.2	1.7
2008 February	4.0	2.3	1.0	-0.1	3.3	1.8

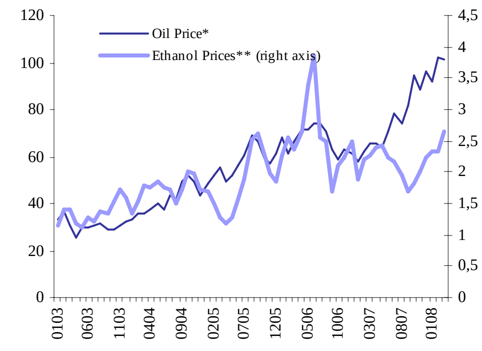
Source: Bloomberg.

The rate of increase in global inflation is mainly determined by the run-up in energy and food prices. Excluding those items, the acceleration in inflation rates slows down markedly (Table 1). Oil prices, a major driver of global inflation, have been shifting steadily higher for a long time now. The surge in oil prices had moderated around mid-2006, but by mid-2007 oil prices were back on the rise (Graph 3). World energy prices also followed a similar pattern (Graph 4). The recent upswing in energy prices can generally be attributed to the rapid growth in the world economy as well as to hedge funds and the increased speculative investment in commodity futures and forward contracts.[2]

[1] OECD (2006), Globalization and Inflation in the OECD Economies, Working Party No:1 on Macroeconomic and Structural Policy Analysis, 26 September 2006.
[2] CBT (2006), Inflation Report, Ankara, October 2006.

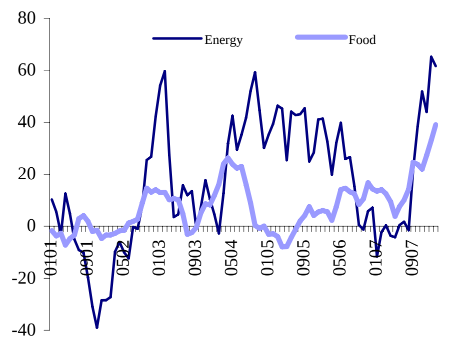
Food prices have also been rising dramatically, particularly since mid-2007 (Graph 4), having accounted for 36 percent of global inflation in 2007.[3] The rise in food prices has a highly significant impact on inflation rates in developing countries. Food inflation is forecast to contribute 70.2, 65.4 and 49.5 percent, respectively, to the inflation rates in Brazil, Chile and Argentina.[3] The increased demand for bio-fuels that hiked the prices for agricultural products is the key driver of food inflation. The huge jump in energy prices and rising environmental and political concerns force developed countries to seek alternative energy sources. The production and consumption of bio-fuels increased rapidly, particularly after the European Parliament adopted the Common Agricultural Policy reform in 2003 and the US Senate approved the Energy Policy Act of 2005.[4] As a result, prices for commonly used bio-fuel crops, such as corn, wheat, sugar cane and canola, started to climb. During the 2004/5 period, 7.3 percent of total corn production was used to produce bio-fuel, but this share is forecast to rise further to 17.2 and 31.4 percent in 2007/8 and 2010/11, respectively.[3] As shown in Graph 3, prices of ethanol, a bio-fuel, have been on the rise for a long time. Their upward trend seemed halted in 2006 but started back in mid-2007. In addition to bio-fuel production, drought-related production cuts in countries producing and exporting major agricultural products and the increased food demand from fast-growing emerging economies, primarily China, provided a further boost to prices.[3] Moreover, reductions in supplies of some agricultural products drive the prices of those products higher due to speculative purchases.[5]

Graph 3. Oil and Ethanol Prices (USD)



* WTI Spot Crude Oil Prices.
** US Ethanol Price per Gallon.
Source : Bloomberg.

Graph 4. World Energy and Food Price Inflation



Source : IMF.

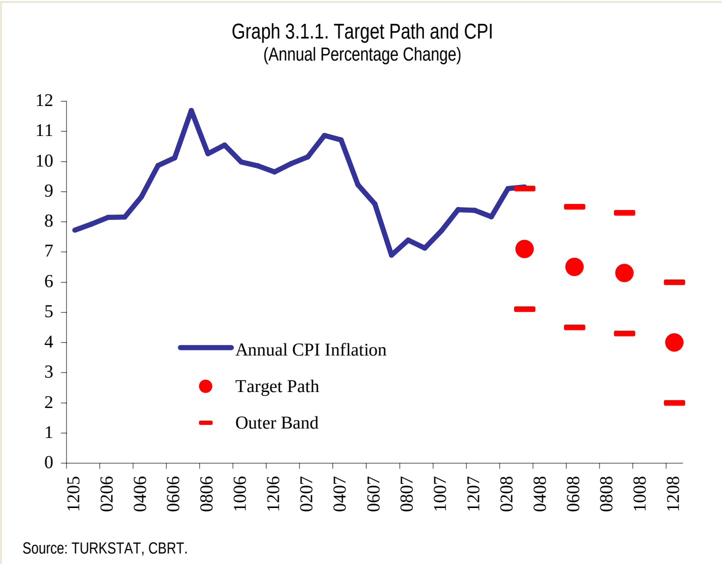
Many estimate that the use of agricultural crops in bio-fuel production will increase further in the upcoming period. Although the US slowdown in 2008 is expected to restrain the demand for energy and food and, thus, to help curb global inflation, the sustained rapid growth in some developing countries like China and India lessens the impact of a contraction in demand. For instance, China accounted for about 85 to 170 percent of the growing demand for several base metals in 2007.[6] On balance, both energy and food prices pose a risk to global inflation. Besides, the share of food in total consumption is higher in developing countries than in developed ones. Therefore the global food inflation exerts a much greater pressure on consumer inflation in those countries.[7]

[3] Central Bank of Argentina (2008), Recent Developments of Commodity Prices, BIS spring economists meeting, unpublished manuscript.
[4] CBT (2007), Inflation Report, Ankara, October 2007.
[5] According to survey results, 45 percent of investors forecast that agricultural commodities will yield the highest return in 2008, while 18 percent of them believe that the highest return will come from investments in energy (Barclays Capital (2007), Global Outlook, December 2007).
[6] Barclays Capital (2007), Global Outlook, December 2007.
[7] The share of food in consumer spending ranges between 15 to 18 percent in the US and Euro area, but in Turkey, Brazil, China and Argentina it falls in a range between 29 and 35 percent, and in some African countries it climbs to 60 percent (Central Bank of Argentina (2008), Recent Developments of Commodity Prices, BIS spring economists meeting, unpublished manuscript and TURKSTAT). The Central Bank of Chile comes up with a similar result (Central Bank of Chile (2008), Inflation Report, January 2008).

3. Inflation Developments

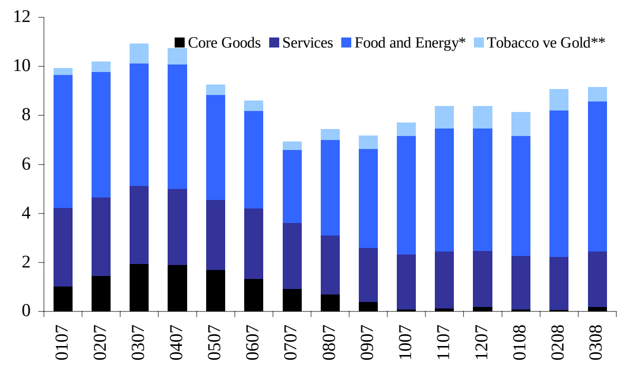
3.1. Inflation

Consumer prices rose by 3.09 percent during the first quarter of 2008, pushing annual inflation up to 9.15 percent (Graph 3.1.1). Therefore, annual inflation fell outside the uncertainty band around the target in March. The sharp rise in annual inflation during the first quarter is mainly driven by soaring food and energy prices. Besides, the recent weakening of the New Turkish lira also partially accounts for the upward shift in inflation.



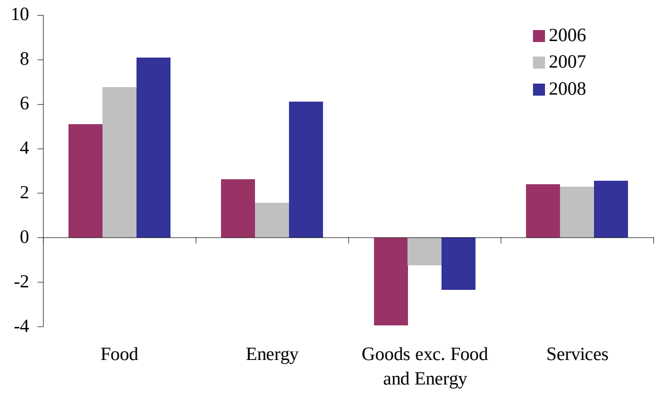
Food, energy, tobacco and gold prices have contributed heavily to annual inflation since the third quarter of 2007. In contrast, prices for services and other goods have made a reduced contribution over the past one year (Graph 3.1.2).

Graph 3.1.2. Contribution to Annual CPI Inflation



* Food and Energy: Food, non-alcoholic beverages and energy.
** Tobacco and Gold: Non-alcoholic beverages, tobacco products and gold.
Source: TURKSTAT, CBRT.

Graph 3.1.3. CPI Sub-Groups
(First-Quarter Percentage Change)

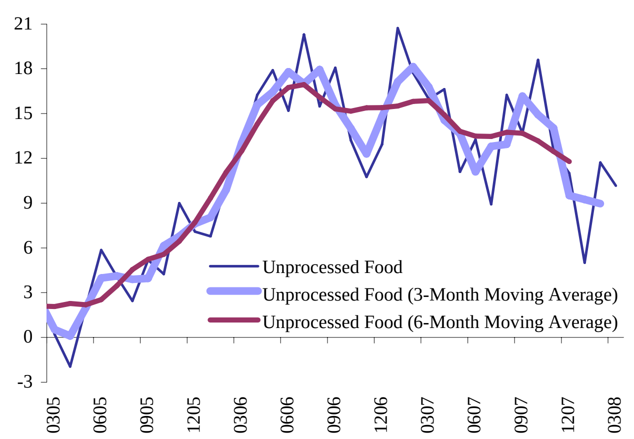


Source: TURKSTAT, CBRT.

The rise in food prices was higher during the first quarter of 2008 compared with previous years (Graph 3.1.3). Domestic supply shortages and record-high world food prices put further upward pressure on domestic food prices. Besides, energy prices increased by 6.11 percent in the first quarter. However, prices for goods excluding food and energy had a better outlook compared to a year earlier, while prices for services maintained at 2006 and 2007 levels. Therefore, the sharper quarterly increase in food and energy prices over the comparable period in 2007 was the major driver of the first-quarter rise in annual CPI inflation. The surge in food and energy prices made up 6.13 percentage points of the annual inflation rate of 9.15 percent in March. In sum, food and energy prices drove inflation higher, while prices of core goods and services remained in positive territory.

The annual inflation in unprocessed food prices ended the first quarter at 10.16 percent, dropping back from its end-2007 level by a slight amount (Table 3.1.1). Referring to moving averages, the rate of increase in unprocessed food prices has generally been on a downward path over the past one year; yet, the group's annual inflation still remains elevated (Graph 3.1.4).

Graph 3.1.4. Unprocessed Food Prices
(Annual Percentage Change and Centered Moving Average)



Source: TURKSTAT, CBRT.

As regards sub-groups, fruit prices edged down on a year-on-year basis in the first quarter, whereas the annual inflation in prices of vegetables and other unprocessed food increased (Table 3.1.1). Fruit and vegetable production in 2007 was down from 2006 (Table 3.1.3). Cutbacks were particularly remarkable in fruit production, leading to a 34.63 percent jump in fruit prices in 2007. The decrease in fruit production was greatest in citrus fruits, particularly, and in grapes, olives (lag year) and hazelnut.

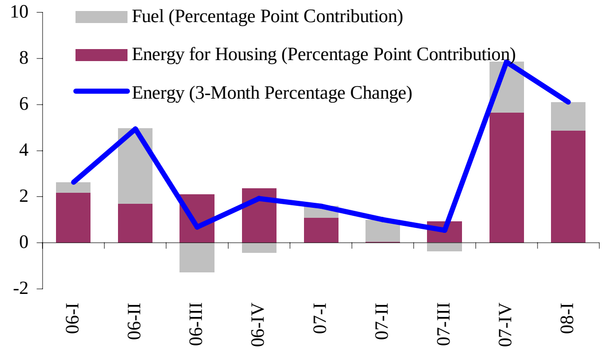
Table 3.1.1. Unprocessed Food Prices

	Quarterly Percentage Change		Annual Percentage Change	
	2007-I	2008-I	2007-IV	2008-I
Unprocessed Food	**11.74**	**10.90**	**10.99**	**10.16**
1. Fruits and Vegetables	20.61	16.81	16.73	13.04
Fresh Fruits	28.53	14.75	34.63	20.19
Vegetables	15.64	18.26	5.48	7.88
2. Other Unprocessed Food	4.78	6.14	6.50	7.89

Source: TURKSTAT, CBRT.

The run-up in energy prices since the final quarter of 2007 intensified in early 2008, amounting to 6.11 percent in the first quarter (Graph 3.1.5). The impact of soaring world oil prices on domestic fuel prices and the upward adjustment in electricity tariffs in January pushed energy prices higher.

Graph 3.1.5. Energy Prices
(Quarterly Percentage Change, Percentage Point Contribution)



Source: TURKSTAT, CBRT.

Prices of goods excluding energy and unprocessed food rose by an annual rate of 6.96 percent in the first quarter of 2008, mainly on account of the continued steep rise in processed food prices and surging gold prices. The annual rate of increase in consumer durables excluding gold totaled -3.77 percent.

Table 3.1.2. Prices for Goods and Services
(Quarterly and Annual Percentage Change)

	2007					2008
	I	II	III	IV	Annual	I
CPI	**2.36**	**1.47**	**0.31**	**4.02**	**8.39**	**3.09**
1. Goods	**2.39**	**1.18**	**-0.11**	**4.65**	**8.29**	**3.27**
Energy	1.58	1.00	0.55	7.85	11.25	6.11
Unprocessed Food	11.74	-5.93	2.23	3.30	10.99	10.90
Goods excl. Energy and Unprocessed Food	-0.10	3.56	-1.01	4.09	6.60	0.23
Processed Food	2.28	0.58	4.26	5.31	12.95	5.61
Durable Goods	1.23	-1.73	-1.15	-1.71	-3.34	3.45
Durable Goods (excl. Gold)	1.13	-1.36	-1.60	-2.41	-4.21	1.58
Semi-Durable Goods	-3.37	7.43	-3.50	7.67	7.86	-1.23
Non-Durable Goods	6.75	-2.07	2.52	4.21	11.69	6.44
2. Services	**2.29**	**2.28**	**1.50**	**2.32**	**8.64**	**2.55**
Rents	3.94	3.33	4.56	3.30	16.01	2.79
Restaurants-Hotels	2.60	1.94	2.27	3.64	10.87	3.13
Transport Services	0.10	1.70	2.10	1.91	5.93	4.10
Other Services	2.10	2.19	-0.36	1.27	5.29	1.68

Source: TURKSTAT, CBRT.

As a sub-group, processed food prices gave the strongest boost to food price inflation by a record 5.61 percent rise in the first quarter over year-ago averages. Changes in both local and global economic environments spur hikes in processed food prices (Box 3.1). Domestic wheat prices increased by around

45 percent over a year and a half, mainly on drought-related domestic crop losses (Table 3.1.3) and rapid international price hikes. In 2007, the domestic production of wheat, barley and corn was 13.9, 23.5 and 7.2 percent down, respectively, from a year earlier. In global markets, agricultural commodity prices rose sharply on the back of supply concerns, coupled with the use of wheat and corn to produce alternative fuels and the rising demand for food in developing countries with an improved welfare, particularly in China and India[1]. Some food-producing countries have recently imposed restrictions or bans on exports of certain agricultural products, which further dampened overall supply and steepened the upward shift in prices.

The marked rise in domestic wheat prices has a greater adverse effect on prices for bread and cereals (Graph 3.1.6), which, accordingly, jumped by 28.39 percent during the past one and a half years. Prices have also risen in other processed food items, up 18.19 percent, amid rising cost pressures from food manufacturers (Graph 3.1.7). Producer prices in the food industry went up dramatically because of the pickup in import prices, particularly in prices of intermediate goods. Besides, the recent weakening of the Turkish lira also added to inflationary pressures in the food industry.

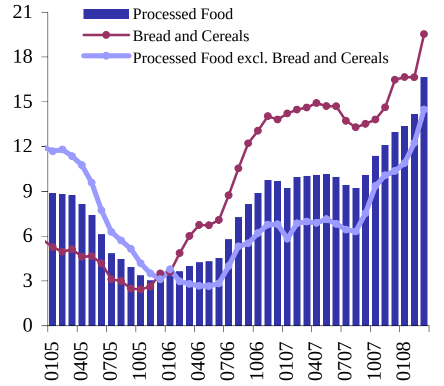
Table 3.1.3. Crop Production (Tons)

	2006	2007	% Change
Field Crops	**59 247 672**	**50 821 550**	**-14.2**
Grains	34 642 986	29 256 990	-15.5
Wheat	20 010 000	17 234 000	-13.9
Corn	3 811 000	3 535 000	-7.2
Barley	9 551 000	7 306 800	-23.5
Potato, dry pulses, edible roots and tubers	5 828 124	5 511 082	-5.4
Oil seeds	1 312 593	1 031 552	-21.4
Sugar beets	14 452 162	12 414 715	-14.1
Fiber crops used in textiles	2 550 068	2 275 044	-10.8
Vegetables	**25 851 612**	**25 675 748**	**-0.7**
Root and tuberous vegetables	2 978 659	3 222 478	8.2
Fruit-bearing vegetables	21 211 268	20 854 683	-1.7
Vegetables otherwise unclassified	1 661 685	1 598 587	-3.8
Fruits	**15 064 987**	**14 409 672**	**-4.3**
Citrus fruits (total)	3 220 435	2 988 664	-7.2

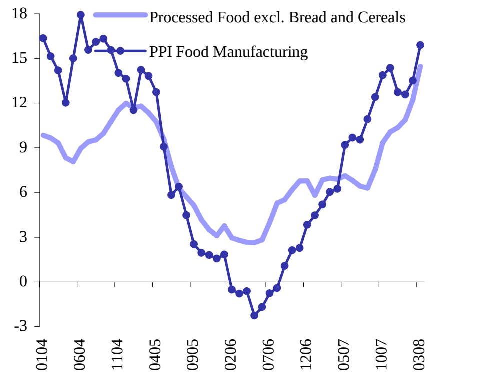
Source: TURKSTAT.

[1] For further information, see Box 2.1 and Box 3.1.

Graph 3.1.6. Processed Food and Sub-Group Prices
(Annual Percentage Change)



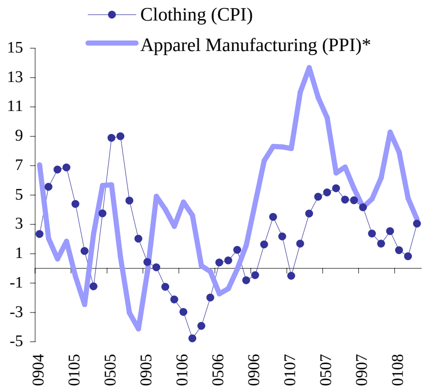
Graph 3.1.7. Prices for Processed Food excl. Bread and Cereals and PPI Food Manufacturing Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

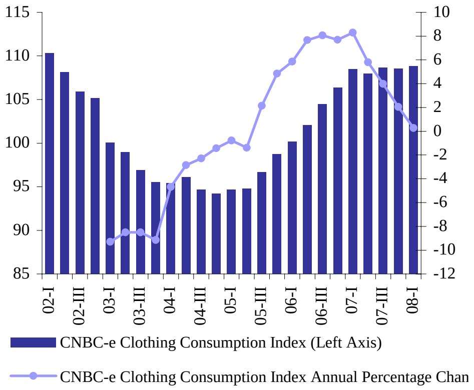
After having increased by 4.08 percent in 2007, clothing and footwear prices have followed a similar pattern to previous years, registering a year-on-year rate of 3.67 percent during the first quarter of 2008. In addition, apparel manufacturing prices fell by a sharp 5.66 percent, but the clothing component of the CNBC-e Consumption Index posted a slight increase over the previous quarter in seasonally adjusted terms (Graph 3.1.8, Graph 3.1.9). On balance, cost and demand conditions are found to have restrained clothing prices in the first quarter. However, the marked rise in textile manufacturing prices in the first three months of the year suggest that the industry will face cost pressures in the upcoming period.

Graph 3.1.8. Clothing and Apparel Manufacturing Prices
(Annual Percentage Change)



* Annual inflation in apparel manufacturing , 2-month moving average.
Source: TURKSTAT.

Graph 3.1.9. CNBC-e Clothing Consumption Index
(Seasonally Adjusted, 3-Month Average and Annual Percentage Change)



Source: CNBC-e.

Higher furniture prices pushed prices of durable goods (excluding gold) up by 1.58 percent during January-March 2008 (Graph 3.1.10, Table 3.1.4). Despite having receded in 2007, furniture prices went up by 4.13 percent in the first quarter. Likewise, furniture manufacturing prices began to rise in early 2008, after having declined in 2007, which indicates that cost factors lead to higher prices in the industry. As a major sub-group of durable goods, prices of automobiles increased at a relatively slow rate (up 1.04 percent) during January-March compared with previous years. Besides, prices of durable goods have been responsive to exchange rate shifts (Graph 3.1.11), a relationship that is highly evident in prices of automobiles and electric and non-electric appliances. Therefore, the recent depreciation of the New Turkish lira is expected to affect prices of durable goods in the short run.

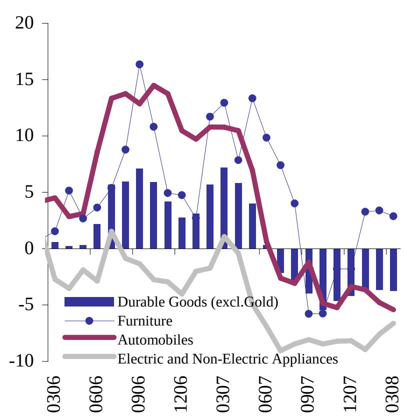
Table 3.1.4. Prices of Durable Goods
(Quarterly and Annual Percentage Change)

	2007					2008
	I	II	III	IV	Annual	I
Durable Goods (excl. Gold)	**1.13**	**-1.36**	**-1.60**	**-2.41**	**-4.21**	**1.58**
Furniture	-0.60	4.50	-6.34	0.94	-1.80	4.13
Electric and Non-Electric Appliances	-0.52	-3.75	-1.80	-1.80	-2.35	1.16
Automobiles	3.22	-2.74	0.71	-4.42	-3.37	1.04
Other Durables	0.82	1.09	-0.52	0.32	1.71	0.04

Source: TURKSTAT, CBRT.

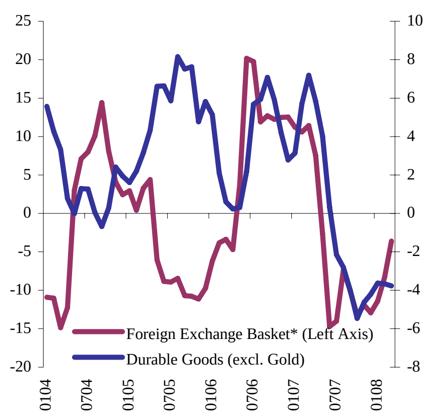
Gold prices have been rising sharply since the second quarter of 2007 in view of global market fluctuations, and went up by a stunning 25.49 percent during the first quarter, making significant contribution to consumer inflation.

Graph 3.1.10. Prices of Durable Goods
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

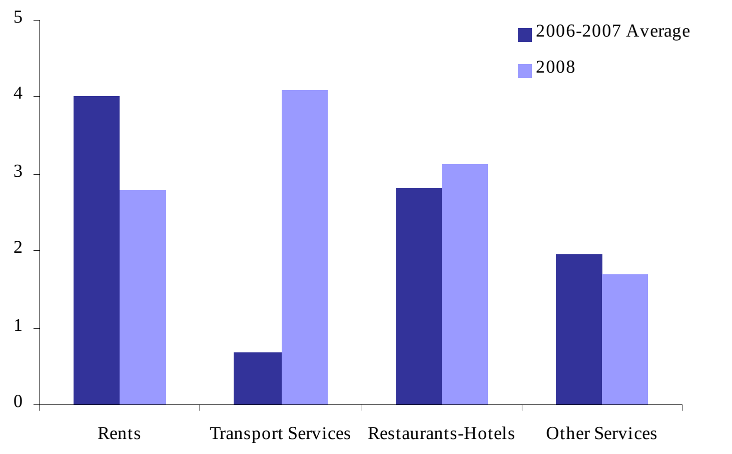
Graph 3.1.11. Durable Goods and Foreign Exchange Basket
(Annual Percentage Change)



* The arithmetic average of USD and Euro Rates.

Services inflation was up 2.55 percent and its descent appeared to have stalled in the first quarter. Rising food prices affect restaurants, and high oil prices have a negative impact on transport services. Yet, prices of other services items, particularly rents, further slowed down (Graph 3.1.12).

Graph 3.1.12. Prices for Services
(First Quarter Percentage Change)

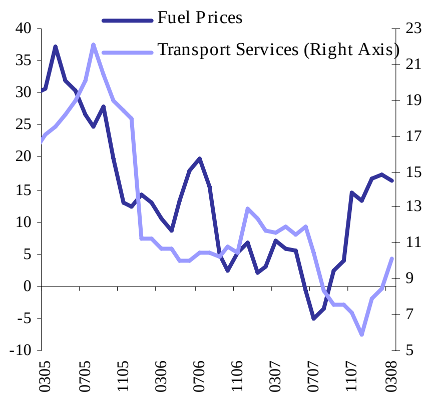


Source: TURKSTAT, CBRT.

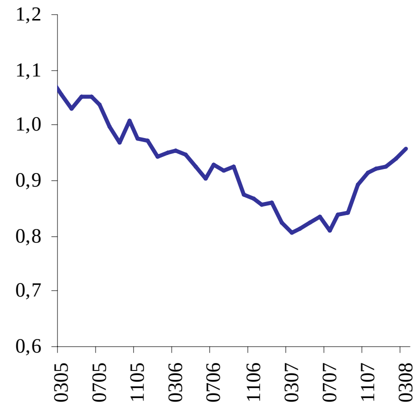
Fuel prices were up 13.9 percent over the past six months on the back of rising world oil prices and tax adjustments. Higher fuel prices have a lagged impact on transport services (Graph 3.1.13).

Prices for restaurant-hotel services remained elevated due to soaring catering prices. Food is a major cost factor; the surge in food prices therefore drive prices of catering services higher. Particularly as the run-up in processed food prices steepened during the second half of 2007, the monthly rate of increase in prices of catering services accelerated markedly (Graph 3.1.14). On balance, food and energy prices has indirectly curbed the downtrend in services inflation.

Graph 3.1.13. Fuel and Transport Services Prices
(Annual Percentage Change)



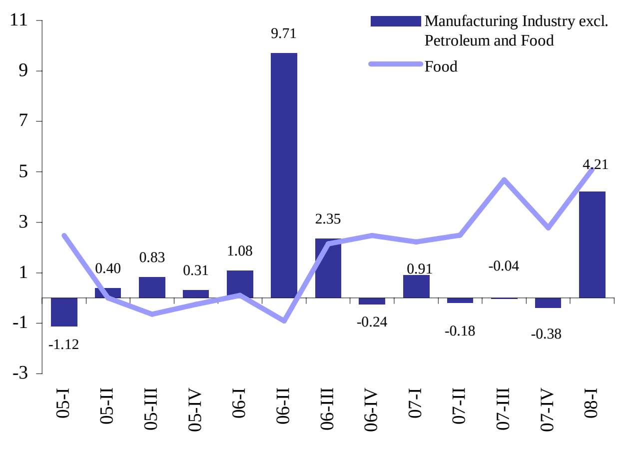
Graph 3.1.14. Catering Services
(Seasonally Adjusted, Monthly Change, 6-Month Moving Average)



Source: TURKSTAT, CBRT.

Changes in producer prices have been of a great concern as to the cost pressures on consumer inflation. After having flattened out during 2007 and made a downward contribution to inflation, manufacturing industry prices excluding petroleum and food went up again by 4.21 percent in the first quarter of 2008 (Table 3.1.5). Moreover, prices of intermediate and capital goods rose at a substantial clip following the depreciation of the New Turkish lira and the pickup in world commodity prices (Graph 3.1.15).

Graph 3.1.15. Manufacturing Industry Prices excl. Oil and Food
(Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

Table 3.1.5. PPI Developments Based on MIGS Classification
(Quarterly and Annual Percentage Change)

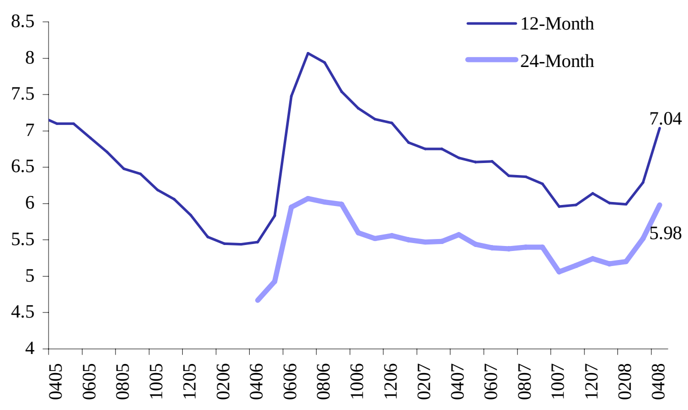
	2007					2008
	I	II	III	IV	Annual	I
Manufacturing Industry excl. Petroleum and	**0.91**	**-0.18**	**-0.04**	**-0.38**	**0.30**	**4.21**
Prices of Intermediate Goods	1.29	0.58	0.15	-1.25	0.75	**7.28**
Prices of Capital Goods	0.03	-1.80	-0.06	-0.48	-2.32	**4.56**
Prices of Durable Goods	0.96	-0.51	-0.80	-3.06	-3.41	**1.59**
Prices of Non-durable Goods	1.54	1.10	2.40	2.88	8.15	**1.33**
Energy Prices	2.64	0.19	4.22	2.65	10.02	**16.89**

Source: TURKSTAT, CBRT.

3.2. Expectations

The continued spike in energy and food prices and the effects of global uncertainties have a negative impact on inflation expectations. Year-end inflation expectations were revised up significantly during the first survey period in March and remained on an upward track for the next periods. Medium-term inflation expectations, however, deteriorated at a more modest rate. In the period since the previous inflation report, 12-month and 24-month-ahead inflation expectations increased by 103 and 81 basis points, respectively. The rise in inflation expectations has increased the risks to the price-setting behavior (Table 3.2.1).

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



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

Recently, the coefficient variation[2] that measures inflation uncertainty has moved upward, confirming the deterioration in 12-month and 24-month-ahead inflation expectations (Table 3.2.1).

Table 3.2.1. CPI Inflation Expectations

Current Period	Survey Period	Year-end Expectations*	12-Month Ahead		24-Month Ahead	
			Average Expectations*	Coefficient of Variation	Average Expectations*	Coefficient of Variation
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
February-08	1	6.47	6.00	0.09	5.17	0.15
	2	6.54	5.99	0.10	5.20	0.13
March-08	1	7.02	6.03	0.11	5.32	0.15
	2	7.27	6.29	0.15	5.52	0.17
April-08	1	8.03	6.77	0.14	5.80	0.16
	2	8.44	7.04	0.14	5.98	0.16

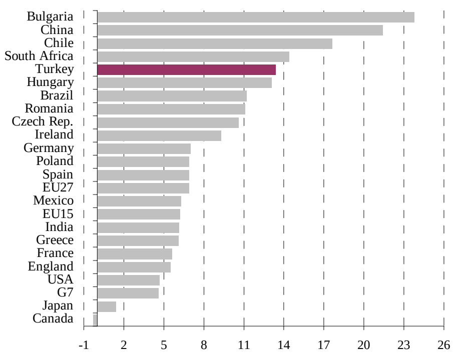
* Average expectation figures presented in the table are specified through comparing the appropriate means designated based on the comparison of arithmetic mean, median, mode, alpha and trimmed mean and extreme value analysis.
Source: CBRT.

[2] 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.

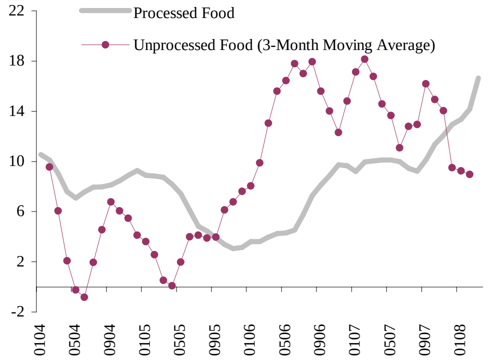
BOX 3.1. RECENT FOOD PRICE DEVELOPMENTS

Consumer inflation fell outside the uncertainty band around the target in the first quarter of 2008, mainly due to record-high food prices. The annual rate of increase in food prices amounted to 13.40 percent in March, accounting for about 3.8 percentage points of consumer inflation. Higher food prices are not only a concern for Turkey but also for most other countries, and put upward pressure on global inflation rates (Graph 1). That impact is more serious in developing countries as their households spend significantly more on food items. Food makes up 28.63 percent of the Consumer Price Index in Turkey and therefore dominates the inflation basket. Besides, many now believe that agricultural commodity prices worldwide will remain elevated in the medium run. In view of these considerations, food price developments in Turkey need to be analyzed in more detail, factors influencing food prices need to be separated to see their individual effects, and thus future assessments are to be made as required.

Graph 1. Food Prices
(Annual Percentage Change, As of the Current Month*)



Graph 2. Processed and Unprocessed Food Prices
(Annual Percentage Change)



*Annual percentage changes compare end-February rates for Japan, India, G7 and South Africa and end- March rates for other countries with the comparable period in 2007.
Source: TURKSTAT, EUROSTAT, OECD-OLIS Bloomberg and related central banks.

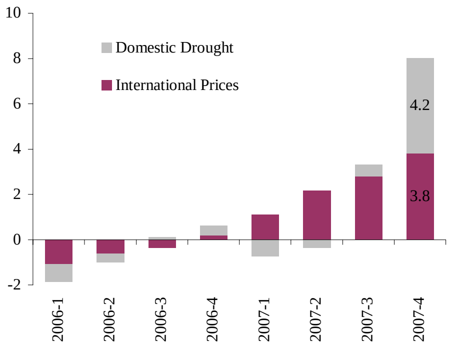
Source: TURKSTAT, CBRT.

Factors Affecting Food Prices in Turkey

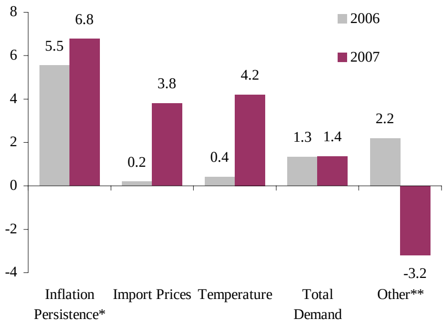
Due to their potentially different pricing dynamics, food items are categorized into two sub-groups: processed food and unprocessed food. The recent hikes in food prices are largely driven by the uptrend in processed food prices (Graph 2). Studies conducted in the Central Bank of Turkey reported that around two-third of the 12.95 percent annual inflation in processed food prices at end-2007 stemmed from severe drought in Turkey and skyrocketing world food prices (Graph 3). These factors contributed to annual processed food inflation by 8.0 percentage points at end-2007, up from 0.6 percentage points at end-2006. The studies also reported that factors such as aggregate demand conditions, which relatively lie within the domain of monetary policy, contributed less to processed food inflation (Graph 4). In contrast, exchange rate shifts and cost factors are concluded to have put downward pressure on processed food prices in 2007. The total impact from routine pricing habits, backward-looking expectations and factors outside the model was up 1.3 percentage points from 2006 to 6.8 percentage points in 2007.[1] These findings show, on balance, that the recent climb in processed food prices was mainly fueled by supply shocks and external factors.

[1] The econometric model used explains about 86 percent of the variation in processed food prices. The contribution from the unexplained share of the variation to the annual processed food inflation was 0.1 and –0.4 points, respectively, in 2006 and 2007.

Graph 3. Contribution to Processed Food Inflation
(Percentage Point Contribution to Quarter-End Annual Inflation)



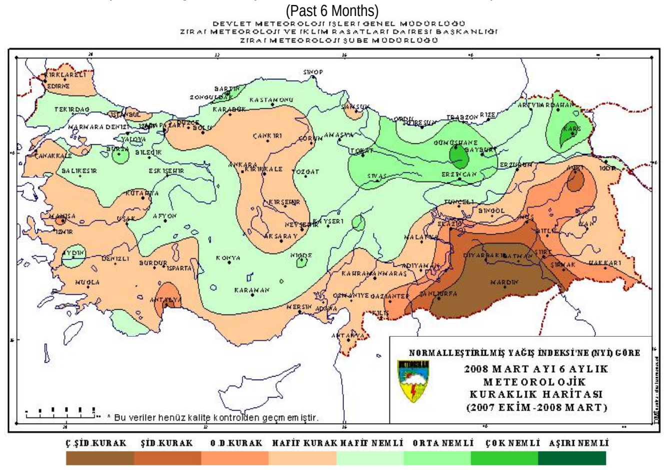
Graph 4. Sources of Processed Food Inflation
(Percentage Point Contribution to Annual Inflation)



* The variable inflation persistence in the model is the sum of the constant term changing each year and the residual. It indicates the total effect of habits in pricing behavior, backward-looking expectations and the factors outside the model.
**Other: Exchange rate, energy prices and other local costs.
Source: CBRT.

On the unprocessed food prices front, changes in fruit and vegetable prices are quite significant. Studies conducted in the Central Bank of Turkey indicate that production, external demand, demand from the food manufacturing industry and fuel prices are the main reasons behind the changes in fruit and vegetable prices. Although the rate of increase in fruit prices decelerated somewhat in the first quarter of 2008, the annual inflation in unprocessed food prices still remains elevated (Graph 2). The slowdown in the exports of unprocessed food helps external demand conditions to make a higher contribution to the downward trend in unprocessed food inflation compared to 2007. The improved weather conditions of the past six months suggest that domestic supply conditions for fruits and vegetables might get better in 2008 compared to a year earlier (Graph 5). However, the areas that still receive little precipitation hold down production growth and lower the possibility of a major correction in fresh fruit and vegetable prices. The rise in diesel fuel prices adds to the upward pressure. Besides, if the first-quarter jump in prices of other unprocessed food items, such as rice, meat and pulses, continues into the upcoming period, the much-awaited correction in fruit and vegetable prices will only have a modest impact.

Graph 5. Drought Severity Based on the Standardized Precipitation Index
(Past 6 Months)



Source: State Meteorological Service.
*Brown colors indicate drought, green colors indicate favorable conditions.

Food Prices Worldwide

International food prices have recently been surging dramatically on the back of both supply and demand pressures and are expected to be on the rise for the next period. Key factors that affect global supply conditions include the recent developments in the amount and use of agricultural lands around the world. Information on the agricultural industry worldwide indicates that productivity gains since the 1990s lagged behind earlier years.[2] In addition, factors such as rapid urbanization and industrialization shift land-use trends in the world towards non-agricultural activities. The global demographic change both boosted the demand for food and caused an employment shift from agricultural towards non-agricultural industries. Moreover, the recent drought that hit most parts of the world created a supply crisis, aggravating the uptrend in food prices. On the demand front, bio-fuels derived from agricultural products serve, and will continue to serve, as an alternative energy source amid rising oil prices (See Box 2.1). Rapid growth rates in China and India and the resulting increase in household incomes put strong demand pressure on international food prices. Another factor that is mostly common in developing countries and has an adverse effect on basic food staples is the inertia in consumer habits, which reduces the possibility of a demand-related price correction as food items are less likely to be substituted by other goods.

As stated by the World Bank, in order to eliminate the abovementioned structural problems, we need a coordinated and comprehensive approach worldwide to reform both trade and agriculture and have to improve production technologies, particularly in agricultural industries. Unless these structural changes are taken into account, the recent run-up in food prices might develop into a permanent position in the medium term, posing a significant risk to price stability in the world, primarily in emerging economies.

Prospects for food prices in 2008 depend on whether world temperatures will continue to rise dramatically and cause crop losses, as they did last year. Early forecasts for 2008 suggest that the weather will be more accommodating than 2007. As measured by current indicators, grain production will particularly rebound from its year-ago levels, but the extent to which supply conditions will improve remains uncertain.

As inflationary pressures in Turkey, triggered by severe drought and related crop losses, have been waning for some time, the rate of increase in processed food prices is likely to decelerate during the second half of 2008. Yet, the imposition of export quotas or bans by countries producing and exporting basic food staples to keep down domestic prices added to 2008 risks.

In sum, as many are increasingly aware that the climb in food prices worldwide will turn permanent in the medium term, the upside risks to domestic food, particularly processed food, prices seem to remain in a foreseeable future.

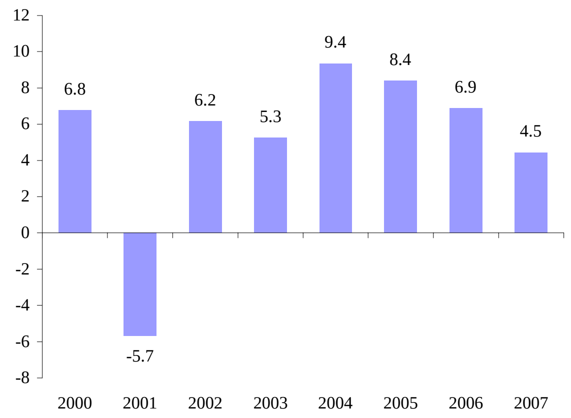
[2] Source: United States Department of Agriculture (USDA), Food and Agriculture Organization (FAO).

4. Supply and Demand Developments

4.1. Supply-Demand Balance

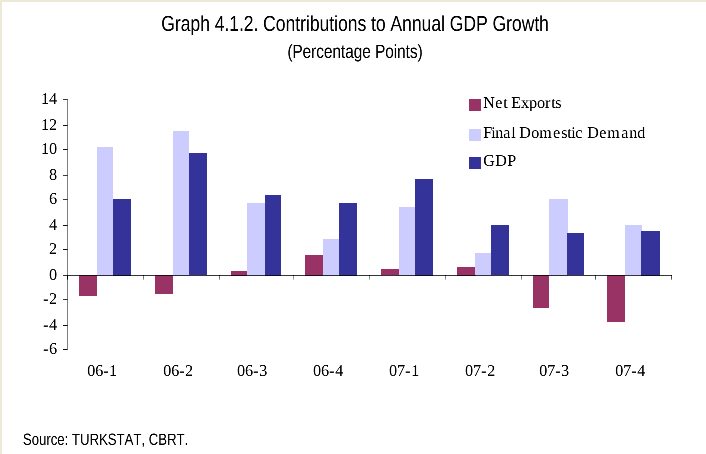
According to new national accounts statistics (base year 1998) released by the Turkish Statistical Institute (TURKSTAT), Turkey's Gross Domestic Product (GDP) expanded by 3.4 percent year-on-year in the final quarter of 2007, hitting an annual rate of 4.5 percent for the entire year (Graph 4.1.1).

Graph 4.1.1. GDP Growth Rates by Years
(Percent)



Source: TURKSTAT, CBRT.

As shown by the demand composition, the fourth-quarter GDP growth was primarily boosted by private consumption (by 1.9 points) and private investment spending (by 1.8 points). Public spending, however, had a limited contribution to growth. Net foreign demand made a large negative contribution of 3.7 percentage point (Graph 4.1.2, Table 4.1.1). In other words, residents have shifted their final demand towards imported goods, and the demand for domestic goods and services has been weak. In fact, excluding the contribution from stock changes, the final-quarter growth rate falls to 0.2 percent.



In seasonally adjusted terms, GDP grew by a quarter-on-quarter rate of 2.1 percent in the fourth quarter of 2007. This growth has a pattern similar to that of rapid-growth periods when domestic demand had been robust, but yields less information for the upcoming period due to the current environment of accumulating stocks and global tensions. Data available for the first quarter of 2008 indicate that the increase in economic activity in the last quarter of 2007 is not of a long-lasting nature. Indeed, during January-February, industrial production stayed at its level in the last quarter of 2007 in seasonally adjusted terms, and is therefore expected to remain unchanged in the first quarter on a quarterly basis.

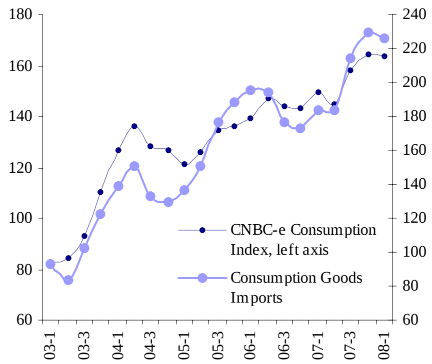
Table 4.1.1. GDP Developments by Expenditures

	2006	2007				2007
	Annual	I	II	III	IV	Annual
1-Consumption Expenditures	5.1	5.5	1.7	7.6	2.7	4.4
Public	8.4	4.7	2.1	3.3	1.6	2.8
Resident Household Expenditures	4.6	5.6	1.6	8.2	2.9	4.6
Domestic Expenditures	4.6	5.6	1.2	6.3	1.9	3.8
Food, Beverages and Tobacco	3.9	7.0	3.7	3.6	0.2	3.5
Clothing and Footwear	-3.9	-0.7	-10.8	-4.3	0.8	-3.9
Furniture, Household Appliances	5.3	7.3	-3.9	2.7	1.0	1.5
Transport-Communication	7.4	3.1	-1.8	12.9	4.9	4.6
Restaurants and Hotels	2.5	7.3	0.3	4.3	-6.6	1.8
2-Fixed Capital Investments	13.3	2.8	1.2	2.1	7.2	3.3
Public	2.6	4.3	8.4	15.9	2.2	7.6
Private	15.0	2.6	0.2	0.0	8.1	2.7
Machinery-Equipment	12.2	-3.2	-3.7	-1.6	11.9	0.7
Construction	20.3	12.9	8.2	2.8	2.2	6.3
3- Stock Changes*	-0.1	1.9	1.8	0.0	3.2	1.7
4-Exports of Goods and Services	6.6	12.5	9.3	4.2	2.5	6.7
5-Imports of Goods and Services	6.9	8.6	5.6	14.4	15.7	11.1
Net Exports*	-0.3	0.4	0.5	-2.6	-3.7	-1.5
6-Total Domestic Demand	7.0	6.8	3.2	5.9	7.0	5.7
7-Total Final Domestic Demand	7.0	4.8	1.6	6.3	3.8	4.1
8-GDP	6.9	7.6	4.0	3.4	3.4	4.5

*Contribution to GDP growth, percentage points.
Source: TURKSTAT.

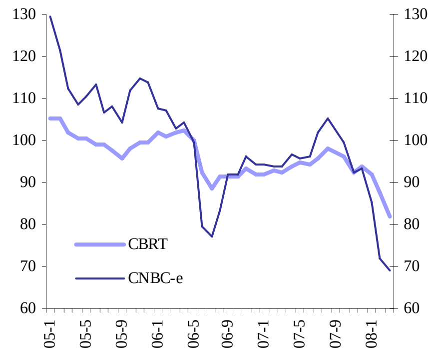
First-quarter indicators for consumption demand are largely consistent with the industrial production data. The seasonally adjusted first-quarter CNBC-e consumption index was virtually flat, while import quantity indexes for consumer goods went down in quarterly terms (Graph 4.1.3). Besides, it is quite remarkable that CNBC-e and CBRT/TURKSTAT consumer confidence indexes have been on the decline since September, when global risks had intensified (Graph 4.1.4). The global credit crunch continues to hold down consumer loans (Graph 4.1.5). Domestic sales of automobiles posted a sharp annual increase in the first quarter on the back of the low base from the comparable period a year ago, but they still lagged behind the fourth quarter (Graph 4.1.6). Besides, domestic sales of white goods declined both on an annual and quarterly basis and fell below the range between 400,000 to 450,000 units in seasonally adjusted terms, registering their lowest level since the first quarter of 2004 (Graph 4.1.6). Changes in spending on household equipment, a sub-group in the CNBC-e consumption index, also signal a slowdown in domestic demand.

Graph 4.1.3. CNBC-e Consumption Index and Import Quantity Index of Consumer Goods
(Seasonally Adjusted)



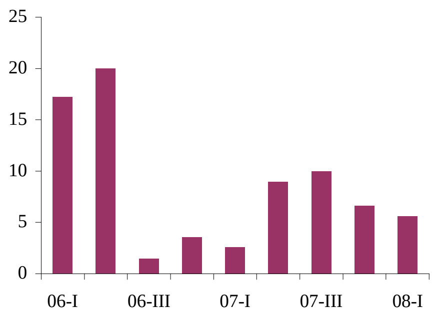
Source: CNBC-e, TURKSTAT, CBRT.

Graph 4.1.4. Consumer Confidence Indexes



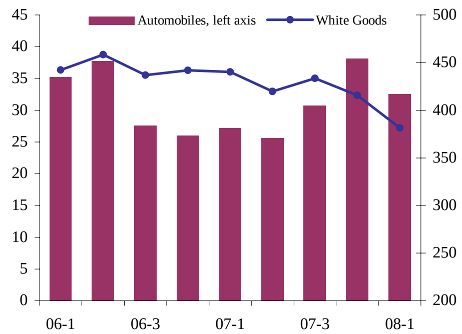
Source: CNBC-e, TURKSTAT, CBRT.

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



Source: CBRT.

Graph 4.1.6. Domestic Sales of Automobiles and White Goods*
(Seasonally Adjusted, Three-Month Average, In Thousands)

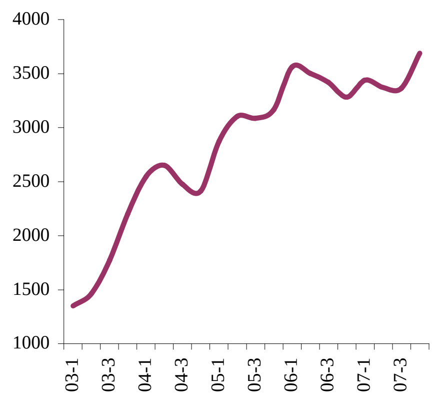


* Latest data on sales of white goods cover the January-February period.
Source: AMA, WGSA, CBRT.

Private sector's machinery-equipment investments, which account for almost half of total investments, declined by 2.8 percent during the first nine months of 2007, with total investments up by a modest annual rate of 2 percent. In the fourth quarter, however, private sector's machinery-equipment investments rose by a dramatic 11.9 percent, pushing the annual rate of increase in total investments significantly up from the first three quarters to 7.2 percent. Accordingly, the contribution of private investments to GDP growth was substantially higher compared to the first nine months of 2007. On a seasonally adjusted basis, private sector's machinery-equipment investments increased rapidly in the fourth quarter, after having edged down since the first quarter of 2006 (Graph 4.1.7).

Graph 4.1.7. Private-Sector Investments on Machinery-Equipment

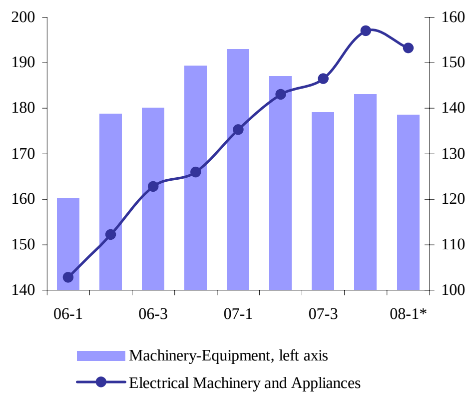
(Seasonally Adjusted, at 1998 Prices, Million New Turkish liras)



Source: TURKSTAT, CBRT.

Graph 4.1.8. Production of Machinery-Equipment and Electrical Machinery and Appliances

(Seasonally Adjusted, 3-Month Average, 1997=100)

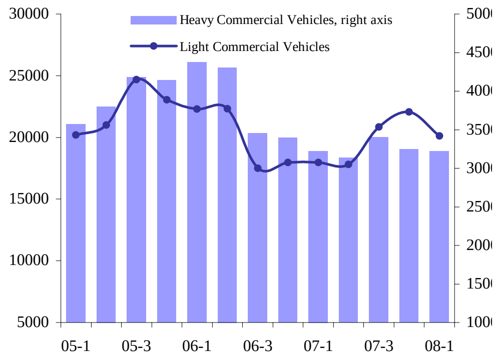


* From January to February.
Source: TURKSTAT, CBRT.

As an indicator for investment demand, the downtrend in machinery-equipment production that started in the second quarter of 2007 continued into the first two months of 2008 (Graph 4.1.8). Accordingly, after a year-on-year fall in the second half of 2007, machinery-equipment production shrunk further at an annual rate of 6.2 percent between January and Februrary. On the other hand, electric machinery production and domestic sales of light commercial vehicles increased annually at a fairly strong rate, but declined quarterly on a seasonally adjusted basis (Graph 4.1.8 and 4.1.9). After having decreased annually since the second quarter of 2006, sales of heavy commercial vehicles rebounded in annual terms in the first quarter but narrowed slightly on a quarterly basis in response to the slump in March (Graph 4.1.9). These indicators point to a slowdown in investment compared to the previous quarter.

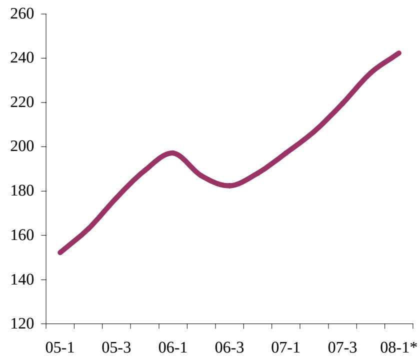
In contrast, imports of capital goods, which saw a dramatic annual growth rate of 34.3 percent during January-February, have pointed to a quarterly acceleration as well (Graph 4.1.10). In sum, machinery-equipment investments are expected to slow down in the first quarter, but remain above their year-ago level thanks to the base effect.

Graph 4.1.9. Domestic Sales of Light and Heavy Commercial Vehicles
(Seasonally Adjusted, in Units)



Source: AMA, CBRT.

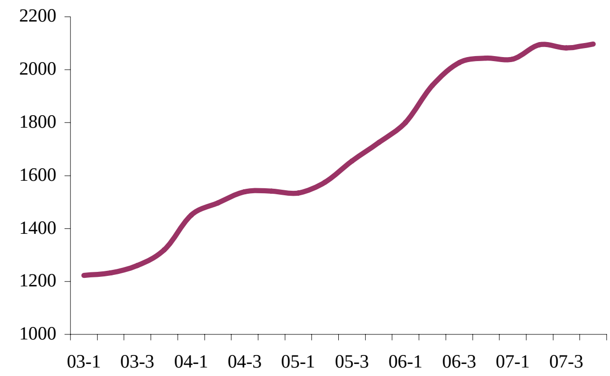
Graph 4.1.10. Import Quantity Index of Capital Goods
(Seasonally Adjusted)



* Covers theJanuary-February period.
Source: TURKSTAT, CBRT.

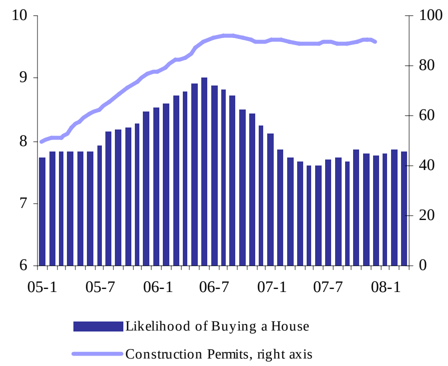
Construction investments followed a similar pattern to private sector's machinery-equipment investments, and slowed down gradually following the financial turbulence in May-June 2006, a trend that continued into the final quarter of 2007 (Graph 4.1.11). The resulting drop in housing demand reduced residential construction permits by 3.9 percent in 2007 (Graph 4.1.12). Accordingly, production rises in housing-related industries have stalled. The production of nonmetallic minerals, which provide intermediate input to construction activity, remained unchanged in 2007 from the preceding year, while furniture manufacturing decreased by 13.8 percent (Graph 4.1.13). The housing sector is expected to be restrained further as credit conditions become tighter in view of the global economic downturn.

Graph 4.1.11. Private-Sector Construction Investments
(Seasonally Adjusted, at 1998 Prices, Million New Turkish liras)



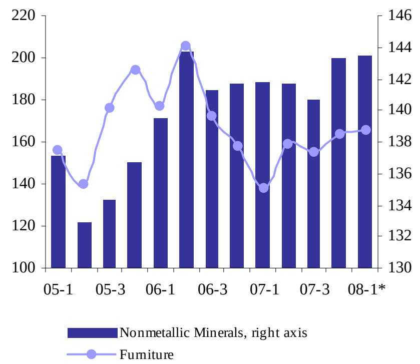
Source: TURKSTAT, CBRT.

Graph 4.1.12. Consumers' Likelihood to Buy or Build a House During the Next 12 Months (Diffusion Index) and Construction Permits
(Million square meters) (Annualized)



Source: TURKSTAT, CBRT.

Graph 4.1.13. Production of Nonmetallic Minerals and Furniture
(Seasonally Adjusted)

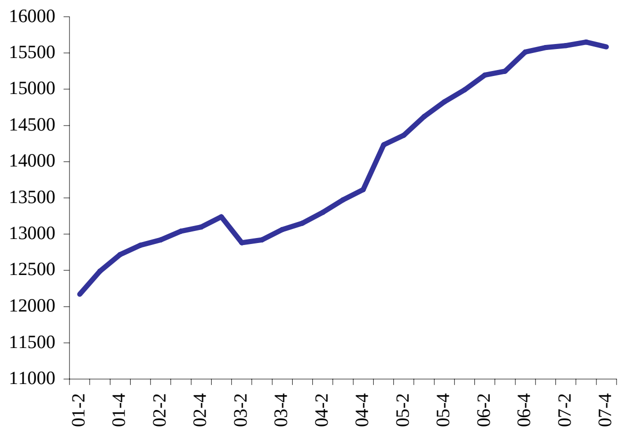


* Covers theJanuary-February period.
Source: TURKSTAT, CBRT.

In sum, readings on the demand for consumption and investment reported a quarterly decline in economic activity in the first quarter. Recently, borrowing conditions have worsened significantly due to spillovers from the global credit squeeze and a prudent monetary policy. Changes in the labor market also suggest a slowdown in domestic demand.

Non-farm employment has slowed down gradually since 2007, along with the downdraft in economic activity (Graph 4.1.14). Indeed, in the aftermath of the crisis in 2001, non-farm employment had registered a stable quarterly growth rate of 1.1 percent on average until end-2006, but it only expanded by a quarterly average of 0.1 percent in 2007.

Graph 4.1.14. Non-Farm Employment
(Seasonally Adjusted, Thousand People)

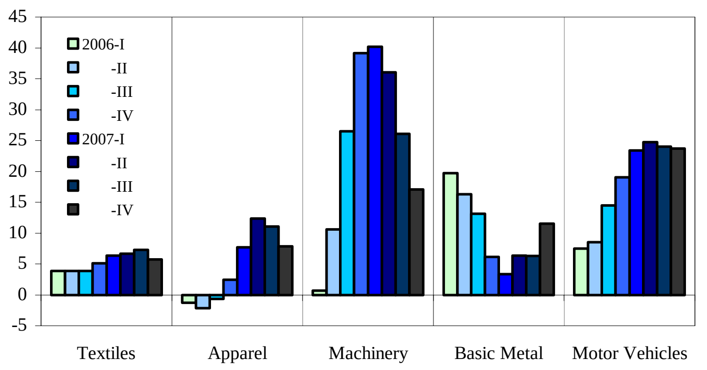


Source: TURKSTAT, CBRT.

4.2. Foreign Demand

The decline in the relative price of imported goods helped foster a quick rebound in imports, and therefore the contribution of net exports to GDP growth, which had been positive since mid-2006, turned negative in the second half of 2007, even though real exports remained strong in terms of quantity. The largest boost to export growth came from the motor vehicles industry, followed by industries such as basic metals, machinery-equipment, electric machinery and appliances. Machinery-equipment exports advanced at a solid pace, but saw some deceleration in 2007. Exports of textiles and clothing were significantly up from 2006, but lagged behind the overall export performance (Graph 4.2.1). Main drivers of the import quantity growth were industries such as basic metals, chemicals and chemical products, and starting from the fourth quarter, motor vehicles and machinery-equipment. The increase in nominal imports, however, resulted mainly from energy imports that account for the largest share of total imports. The sizable fourth-quarter increase in oil and natural gas prices helped energy imports provide the strongest boost.

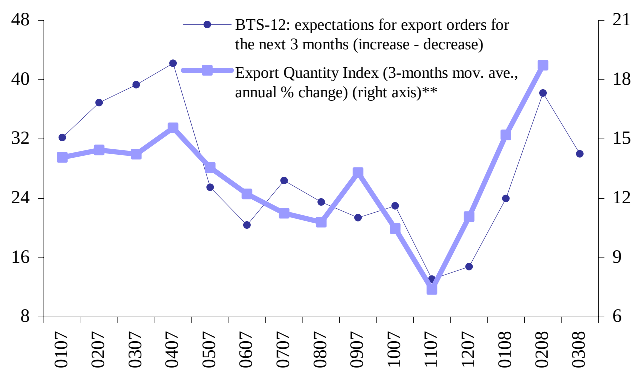
Graph 4.2.1. Export Quantity Index Growth Rates By Industries
(Annualized, Annual Percentage Growth)



Source: TURKSTAT.

Recent data indicate that the marked growth in exports and imports has continued into the first quarter of 2008. Although growth in real imports had been much stronger than exports since mid-2007, real export growth again outpaced that of real imports during January-February 2008 thanks to solid gains in real exports rather than slowing real imports. The main source of export growth was the strong performance of industries such as basic metals, particularly gold, and motor vehicles. Besides, statistics released by the Turkish Exporters' Assembly (TEA) showed that exports have continued their upward trend in March and April. Moreover, "expectations for export orders for the next three months" from CBRT's Business Tendency Survey (BTS) are expected to soar further in the second quarter of 2008, though they declined slightly in March (Graph 4.2.2).

Graph 4.2.2. Expectations for Export Orders and Export Quantity Index
(For the quantity index: annualized, annual percentage growth)*

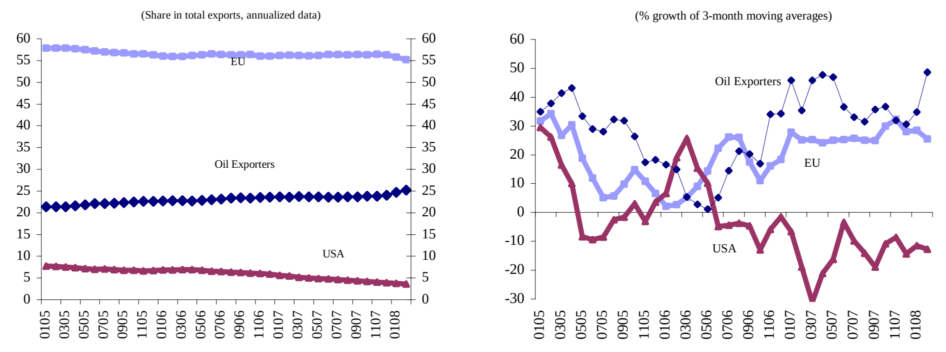


* The export quantity index graph lags by one month.
** Estimates for the quantity index of March depend on TIM figures.
Source: TURKSTAT, CBRT.

The impending global recession will have a depressing effect on import demand, posing a major threat to Turkey’s export performance. Exports to US have accounted for a remarkably reduced share of total exports for the past few years. Exports to EU member states, however, have made up more than 50 percent of total exports with no visible slowdown. Yet, the increased share of exports to oil-exporters and to countries other than the EU and the US has lowered the share of exports to EU member states that had been steady for a few years (Graph 4.2.3). The continued increase in exports to countries other than the EU and the US is a positive development regarding foreign demand.

Real imports remained relatively stable during the first quarter of 2008. However, given both the recent weakening of the New Turkish lira and the impending slowdown in domestic demand, the rate of increase in import quantity will likely begin to decelerate by the second quarter and net exports will make an added contribution to GDP growth. In view of these developments, the trade deficit is expected to expand at a relatively slower rate in 2008. On the other hand, a further uptick in prices of oil and other commodities on world markets will continue to pose a risk to the foreign trade deficit.

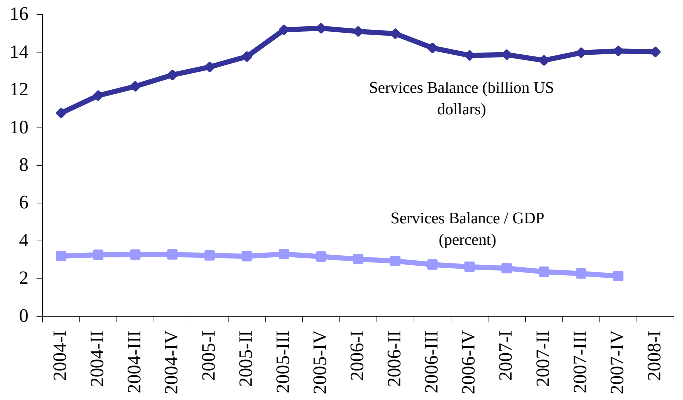
Graph 4.2.3. Exports Developments by Country Groups*
(Percent)



*Oil exporters include OPEC, Russia and Mexico as a whole.
Source: TURKSTAT.

The surplus in the services account, a major component to narrow down the current account deficit, has barely increased since 2006 and lost its weight in GDP. This was mainly attributable to the growth in services expenditures, particularly in residents’ spending on foreign travel and insurance. Developments in the balance of payments during January and February 2008 suggest that this outlook was maintained in the first quarter of 2008.

Graph 4.2.4. Services Account of the Balance of Payments* and GDP

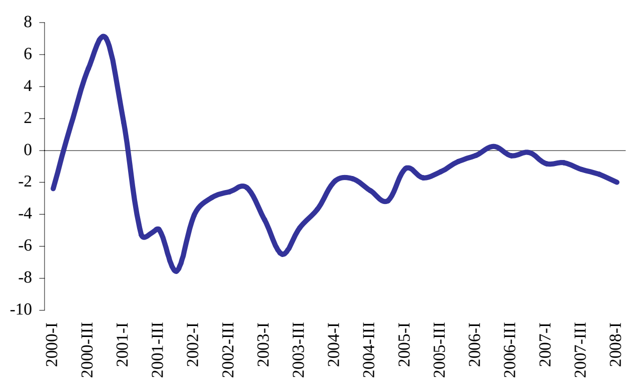


* Includes our estimate for the services balance of March and the resulting first-quarter data.
Source: CBRT, TURKSTAT.

On balance, the contribution of net exports to GDP growth, which had been increasingly negative in the third and fourth quarters of 2007, is expected to be less negative in the first quarter of 2008 and turn positive by the second quarter.

To sum up, the reduced propensity to spend, resulting from global liquidity problems and other uncertainties, is predicted to put further pressure on economic activity and employment growth. Thus, aggregate demand conditions are expected to have an added support for disinflation in 2008 (Graph 4.2.5).

Graph 4.2.5. Output Gap
(Percent)



Source: CBRT.

4.3. Unit Labor Costs

According to the "Index of Production Workers and Hours Worked in Production in Manufacturing Industry" released by the Turkish Statistical Institute, employment in the manufacturing industry rose by 1.8 percent in the fourth quarter of 2007 over a year earlier (Table 4.3.1). After having declined in the second and third quarters, labor productivity in the manufacturing industry experienced a modest bounceback thanks to the relatively strong fourth-quarter gain in production. As the growth in real wages was outpaced by the rebound in labor productivity, real unit wages fell by 2.3 percent in the fourth quarter and by 1.9 percent for the entire year (Graph 4.3.1). Accordingly, real unit wages continued to support disinflation, though at a lesser extent in 2007.

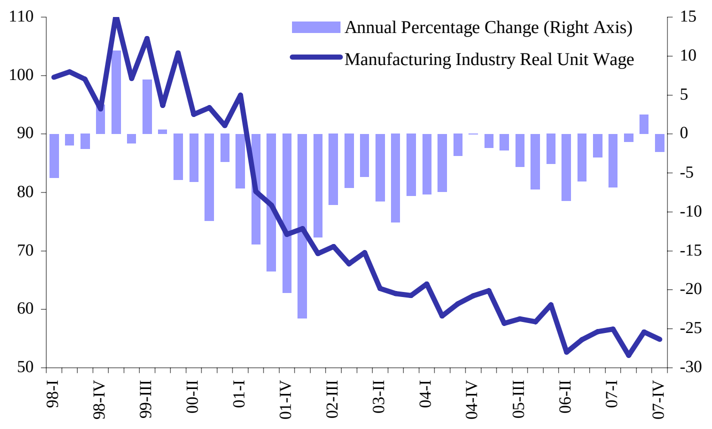
Table 4.3.1. Employment, Real Wages and Productivity Developments in Manufacturing Industry
(Annual Percentage Change)

	2005	2006					2007				
	Annual	I	II	III	IV	Annual	I	II	III	IV	Annual
Employment(1)	-0.7	-1.9	-1.4	-0.7	1.2	-0.7	2.4	2.0	2.2	1.8	2.1
Public	-8.1	-3.3	-3.8	-5.7	-2.9	-4.1	-3.2	-3.8	0.6	0.0	-1.5
Private	0.1	-1.9	-1.2	-0.2	1.6	-0.4	2.7	2.5	2.3	1.9	2.3
Wages(2)	2.0	1.0	0.5	0.0	2.1	0.9	-2.1	-0.5	3.5	1.6	0.6
Public	8.0	-3.9	-2.7	-4.0	-1.5	-3.0	0.4	-2.1	3.8	-0.1	0.5
Private	1.7	1.9	1.3	1.2	3.1	1.9	-2.0	0.1	3.5	1.9	0.9
Earnings(3)	1.8	0.3	0.4	0.0	2.8	0.9	-1.3	-0.1	3.7	0.6	0.7
Public	6.1	-3.3	-2.4	-0.4	0.0	-1.5	1.1	0.3	3.0	0.8	1.3
Private	1.9	1.3	1.2	0.7	4.0	1.8	-1.0	0.5	3.9	0.8	1.0
Productivity(4)	6.0	5.0	9.9	6.5	5.2	6.7	5.1	0.5	1.1	3.9	2.6

(1) Manufacturing Industry Employment Index, 1997=100.
(2) Index of Real Wages Per Working Hour, 1997=100.
(3) Index of Real Earnings Per Worker, 1997=100.
(4) Index of Partial Productivity Per Working Hour, 1997=100.
Source: TURKSTAT, CBRT.

In order for real unit wages to support 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 January Inflation Report. Moreover, it is still of great importance that the incomes policy is properly implemented so as to prevent the deterioration of inflation expectations.

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



Source: TURKSTAT, CBRT.

BOX 4.1. UPDATE OF NATIONAL ACCOUNTS DATA

In March, the Turkish Statistical Institute published new national accounts figures (base year 1998) according to the European System of Accounts (ESA-95). Below we provide a brief comparison of the previous and the revised national accounts series and discuss the differences between the series with respect to the information they convey about economic activity. The latest data from the national accounts series with base year 1987 were available through the third quarter of 2007, and therefore we did not include the fourth-quarter data in our final analysis.

In terms of production, the new national accounts series have an increased share of services and a reduced share of agriculture and industry. The increase in the share of services was largely due to a boom in the value added share of financial institutions and a strong quarterly growth in that sector over the whole period, resulting from the new methodology. In the previous series, the value added at constant prices was estimated using changes in the number of employees, but in the new series, the estimation of the value added at constant prices is obtained by deflating financial institutions' activities by the CPI. As the number of employees has not increased since 2001, percentage shares and growth rates of the financial institutions sector were calculated too low in the previous series. Besides, the value added produced by new financial institutions such as participation banks and factoring companies is now included in the new series. The share of the financial institutions sector has amounted as high as 10 percent in the new series (9.4 percent during January-September 2007), while the growth rate of the sector has risen quite markedly over the past few years (Table 1).

Table 1. Percentage Shares and Growth Rates of Services in GDP

		At 1987 Prices				At 1998 Prices			
		2004	2005	2006	2007*	2004	2005	2006	2007*
Construction									
	Growth	4.6	21.5	19.4	11.5	14.1	9.3	18.5	6.4
	Share	3.7	4.2	4.7	5.0	5.8	5.8	6.4	6.4
Trade									
	Growth	13.2	8.1	6.5	4.5	13.8	9.5	6.3	5.8
	Share	20.5	20.6	20.7	20.8	13.1	13.2	13.1	13.3
Restaurants-Hotels									
	Growth	10.4	3.1	2.3	-3.3	6.8	0.4	2.5	1.7
	Share	3.4	3.3	3.2	2.9	2.2	2.0	1.9	2.0
Transport-Communication									
	Growth	6.8	8.8	3.1	4.4	10.7	11.7	6.8	8.1
	Share	13.3	13.5	13.1	12.8	13.9	14.3	14.3	14.8
Financial Institutions									
	Growth	1.1	-0.2	2.2	7.4	14.0	13.6	14.0	10.6
	Share	1.7	1.6	1.5	1.6	8.3	8.7	9.3	9.4
Business and Personal Services									
	Growth	8.0	7.4	5.2	3.0				
	Share	2.2	2.2	2.2	2.2				
Real Estate									
	Growth					13.2	10.2	12.6	14.8
	Share					2.8	2.8	3.0	3.1
Government Services									
	Growth	1.2	0.8	2.0	1.2				
	Share	3.8	3.6	3.4	3.3				
Public Management									
	Growth					3.1	-5.0	0.1	0.7
	Share					3.9	3.4	3.2	3.0
Education									
	Growth					1.1	4.3	5.2	8.3
	Share					2.1	2.0	2.0	2.0
Health Care									
	Growth					-1.1	17.8	3.9	0.3
	Share					1.1	1.2	1.2	1.2
Other Social Services									
	Growth					4.7	5.3	9.1	6.5
	Share					1.6	1.5	1.6	1.6

* First nine months

Construction has increased its share of GDP by around 50 percent in the new series. Previously, the value added of the construction sector had been calculated by using the data on construction and occupancy permits and by assuming a 5-year construction deadline, whereas, in the new series, a commodity flow method that estimates the output of construction-related sectors is added. This new method, therefore, helps facilitate the use of the output of manufacturing industries, particularly nonmetallic minerals, which provide intermediate input to construction, as a benchmark for the value-added of the construction sector and keeps the user abreast of latest changes in construction activity. Other changes in the services sector are, briefly, the replacement of business and personal services with real estate, financial leasing and business activities plus the itemization of government services into sectors such as public management, education, health care.

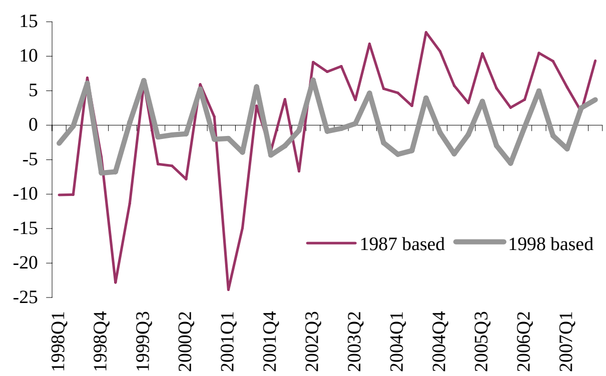
In terms of expenditures, the new national accounts series have an increased share of private expenditures (consumption and investment) and a reduced share of public expenditures (Table 2). In addition, the percentage shares of both exports and imports have fallen, resulting in a decline in the exports-to-GNP ratio.

Table 2. Comparison of GDP Series on Expenditures Side
(at Current Prices, Percentage Shares)

	Resident Household Expenditure		Government Final Consumption Expenditure		Gross Fixed Capital Formation		Private Expenditures (Consumption+ Investment)		Government Expenditures (Consumption +Investment)		Exports of Goods and Services		Imports of Goods and Services	
	1987	**1998**	**1987**	**1998**	**1987**	**1998**	**1987**	**1998**	**1987**	**1998**	**1987**	**1998**	**1987**	**1998**
1998	69.2	66.5	12.7	10.3	24.6	22.9	87.6	84.7	18.8	14.8	24.3	21.3	27.9	20.2
1999	72.2	68.5	15.2	12.2	21.9	18.9	88.4	83.0	20.9	16.6	23.2	19.4	26.9	19.3
2000	71.5	70.5	14.1	11.7	22.4	20.4	87.9	86.2	20.1	16.4	24.0	20.1	31.5	23.1
2001	72.0	68.4	14.2	12.4	18.2	15.9	84.6	80.1	19.8	16.6	33.7	27.4	31.3	23.3
2002	66.4	68.0	14.0	12.7	16.6	16.7	77.7	80.4	19.3	17.1	29.2	25.2	30.7	23.6
2003	66.6	71.2	13.6	12.2	15.5	17.0	77.9	84.9	17.8	15.6	27.4	23.0	30.7	24.0
2004	66.1	71.3	13.2	11.9	17.8	20.3	80.2	88.7	16.9	14.9	28.9	23.6	34.7	26.2
2005	67.4	71.7	13.1	11.8	19.6	21.0	82.8	89.4	17.3	15.1	27.4	21.9	34.0	25.4
2006	66.4	70.5	13.1	12.3	21.0	22.3	83.1	89.4	17.4	15.7	28.2	22.7	35.9	27.6
2007 (9-Month)	67.4	70.3	13.1	12.4	21.6	21.4	85.3	88.0	16.8	16.1	28.5	22.1	36.5	26.9
1998-2006 (Cumulative)	67.5	70.4	13.5	12.1	18.9	19.8	81.8	86.6	18.0	15.7	28.1	23.1	33.1	25.1

Another striking feature of the new national accounts series by expenditure approach is that stock changes have a significantly reduced share in GDP (Graph 1). Previously, the sum of stock changes and statistical discrepancy had been constantly positive since 2002, while in the new series, stock changes can take both positive and negative values as required (stock changes include statistical discrepancy). We believe that the replacement of a constant value added/output ratio with a variable ratio in the manufacturing industry has brought stock changes down to moderate levels.

Graph 1. Stock Changes/GDP
(at Current Prices, Percent)



Source: TURKSTAT.

Private consumption expenditures were recorded as resident household consumption expenditures in the 1987-based series, but are now itemized as resident household consumption expenditures in and out of the economic territory and non-resident household consumption expenditures in the economic territory. Private consumption expenditures are calculated as residents' and non-residents' spending in the economic territory, minus non-residents' spending in the economic territory, plus residents' spending out of the economic territory. In the 1987-based series, private consumption expenditures were broken down in five items, whereas in the 1998-based series they are detailed in a functional expenditure category with ten items (Table 3).

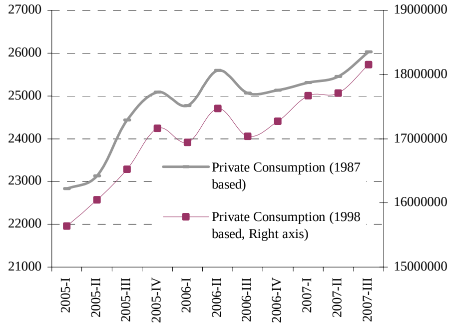
Table 3. Private Consumption Expenditures

1987	Share	1998	Share
Food-Beverages	32.9	Food, Beverages and Tobacco	27.0
Durable Goods	13.9	Clothing and Footwear	8.3
Semi- and Non-Durable Goods	14.9	Housing, Water, Electricity, Gas and Other Fuels	16.4
Energy-Transport Communication	19.5	Furniture, Household Appliances and Routine Maintenance of the House	7.8
Services	11.5	Health	3.7
Ownership of Dwelling	7.1	Transport and Communication	17.8
		Recreation and Culture	4.8
		Education	1.0
		Restaurants and Hotels	6.0
		Miscellaneous Goods and Services	7.1
Total	100.0	Total	100.0

Note: The final consumption expenditure in the 1987-based series uses data on residential and non-residential household spending in the economic territory for the 1998-based series. Calculations employ cumulative data between 1998 and 2006.

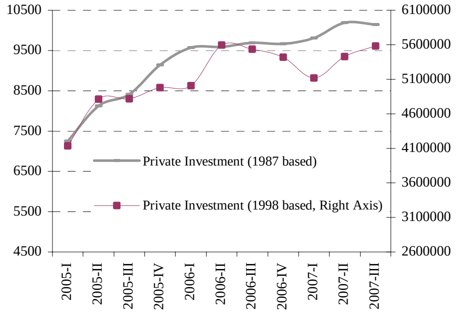
Below are the seasonally adjusted data on GDP and major demand components (private consumption and investment) to help analyze whether the update of national accounts has had an impact on the general trend of economic activities (Graph 1-3). Seasonally adjusted private consumption expenditures trend likewise in both series. Yet, private investment expenditures are more volatile in the 1998-based series. Besides, both demand components and the GDP were influenced by the monetary tightening of the second half of 2006 that had a depressing effect on economic activities. Despite some differences (for example, recent annual growth rates are higher in the new series), both series follow a similar pattern in general.

Graph 1. Private Consumption
(Seasonally Adjusted, at Constant Prices, Thousand TRY)



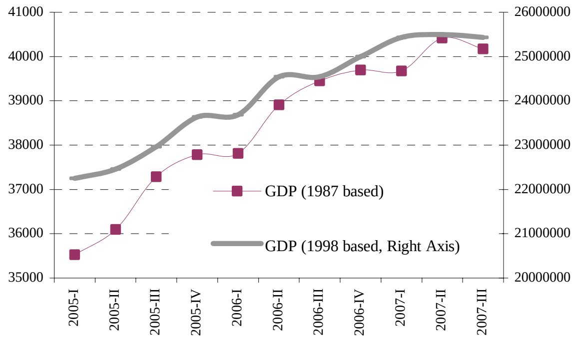
Source: TURKSTAT, CBRT.

Graph 2. Private Investment
(Seasonally Adjusted, at Constant Prices, Thousand TRY)



Source: TURKSTAT,CBRT.

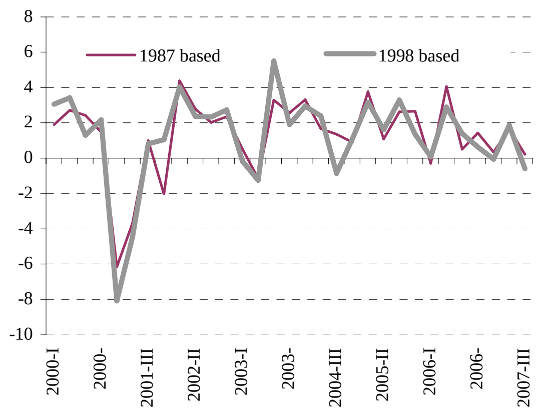
Graph 3. GDP
(Seasonally Adjusted, at Constant Prices, Thousand TRY)



Source: TURKSTAT, CBRT.

By quarterly growth rates, the revised national accounts series remain quite the same (Graph 4). In sum, the update of national accounts data is considered, from a monetary policy point of view, to have little or no impact on demand conditions and on the economic outlook.

Graph 4. Quarterly Change in GDP
(Seasonally Adjusted, Percent)



Source: TURKSTAT, CBRT.

5. Financial Markets and Financial Intermediation

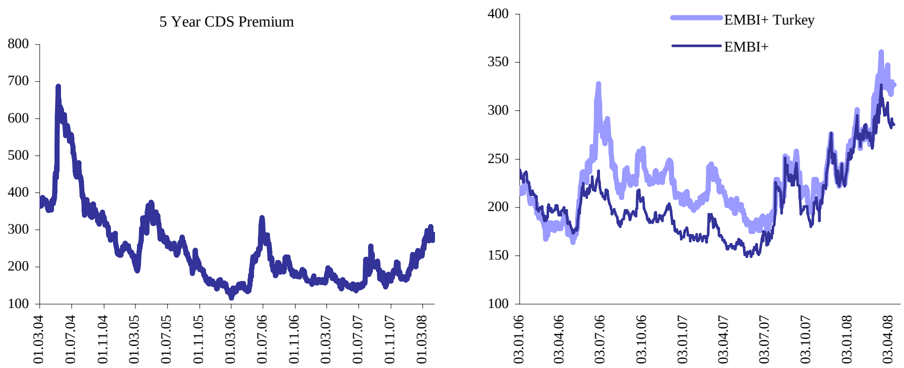
5.1. Financial Markets

The deterioration in risk perceptions strengthened as downside risks to growth in advanced economies, primarily in the US, and to their credit markets intensified in the first quarter of 2008.

Available first-quarter data have added to concerns over sluggish economic growth in the developed world, while the liquidity squeeze in financial markets has deepened and losses on asset-backed securities have soared to a record high, which, altogether, prompted central banks of advanced economies to take measures to provide larger liquidity facilities for troubled markets. Those measures, however, had a short-lived and limited impact on financial volatility.

Uncertainties over developed economies caused emerging markets to fluctuate through the channel of risk aversion and tight global liquidity conditions. Being on the rise since mid-2007, risk premiums in emerging economies climbed further in the first quarter. Accordingly, Turkey’s risk premium on the 5-year Credit Default Swap (CDS) and the JP Morgan EMBI+ Turkey index has widened (Graph 5.1.1). Moreover, volatility risk premiums in emerging markets and their sensitivity to global risk appetite continued to increase (Box 5.1). 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 and to stay volatile.

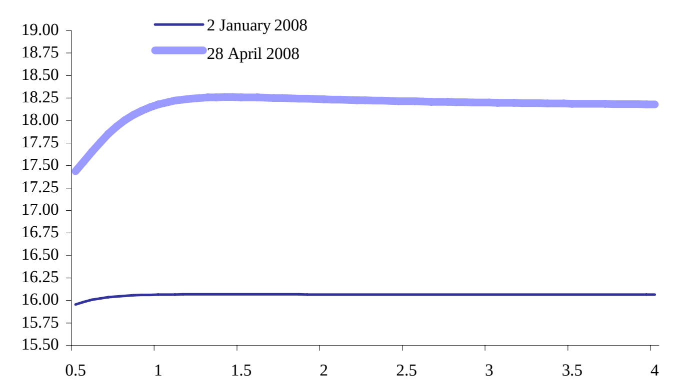
Graph 5.1.1. Risk Premium Indicators



Source: Bloomberg.

Despite CBRT's policy rate cuts, the increased financial volatility pushed market rates up in the first quarter. In each maturity range, yields on April 28, 2008 were much higher than those on January 2, 2008. The recent uptrend in market rates was largely boosted by global spillovers. In addition, the deterioration in inflation expectations resulting from soaring food and energy prices and exchange rate movements is also believed to have played a major role in driving market rates higher (Graph 5.1.2).

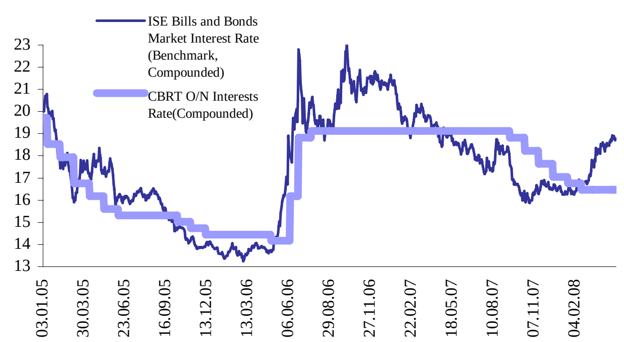
Graph 5.1.2. Yield Curves
(Percent)



Source: CBRT.

Against this background, after a steady decline since early 2007, the interest rate on the benchmark government security in the Istanbul Stock Exchange (ISE) Bonds and Bills Market stopped falling in the fourth quarter and reversed its downward trend in the first quarter of 2008. In this period, the benchmark security rate outpaced CBRT's overnight rate (Graph 5.1.3).

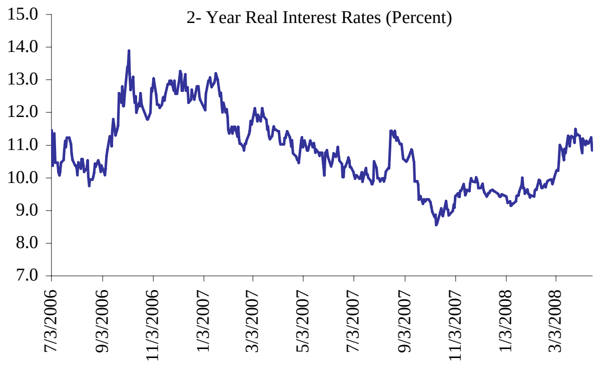
Graph 5.1.3. Changes in Interest Rates
(Percent)



Source: ISE, CBRT.

There was also a marked increase in medium-term real interest rates in the first quarter (Graph 5.1.4). Higher real interest rates are expected to put further pressure on demand conditions in the upcoming period. In addition, changes in global risk perceptions and inflation expectations remain of great concern.

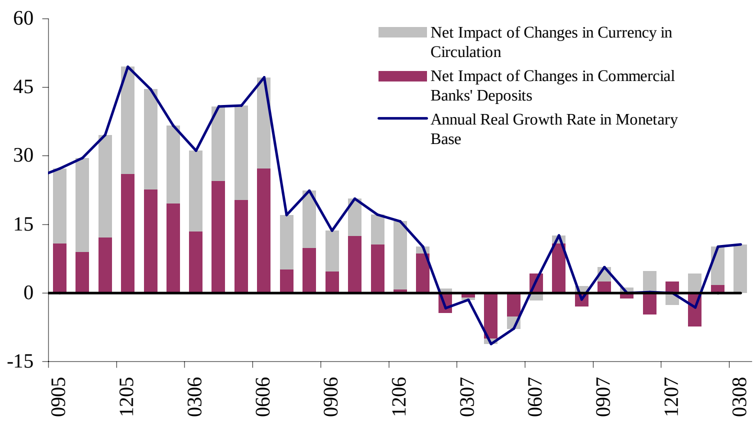
Graph 5.1.4. Changes in Real Interest Rates*
(Percent)



* Two-year real interest rates, calculated using 2-year nominal interest rates from the yield curve and inflation expectations from CBRT's Expectations Survey.
Source: ISE, CBRT.

After having remained unchanged year-on-year in the fourth quarter of 2007, the monetary base climbed up in February and March 2008 in response to the increased amount of currency in circulation. That climb has most likely resulted from an exchange of less liquid assets with more liquid assets, triggered by increased uncertainty, and is therefore believed to bear no evidence of inflationary pressures (Graph 5.1.5).

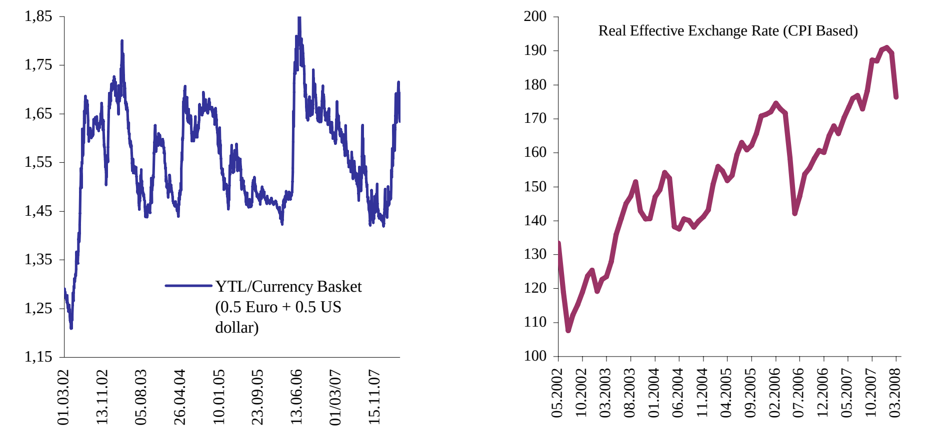
Graph 5.1.5. Annual Real Growth in Monetary Base
(Percent)



Source: CBRT.

Risks perceptions dampened by uncertainties over global economy have pushed down the value of the New Turkish lira against major currencies. The rise in the level and volatility of the exchange rate might have an adverse impact on inflation expectations (Graph 5.1.6).

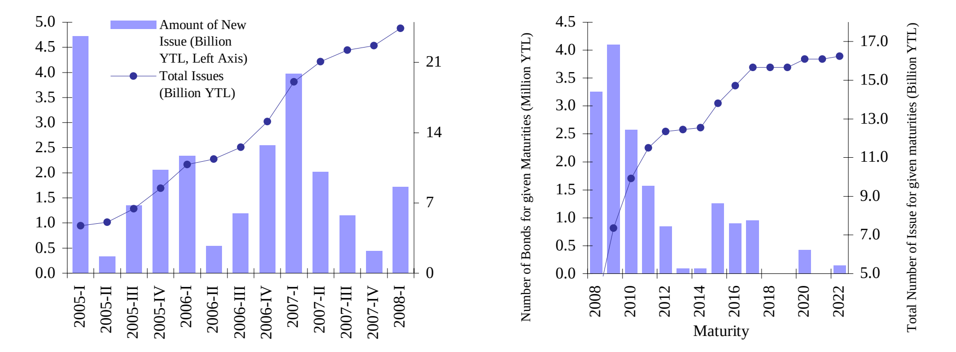
Graph 5.1.6. Changes in Exchange Rates



Source: CBRT.

The ongoing global liquidity crisis and the further reduced international risk appetite continued to tighten financing conditions. Although the amount of YTL-denominated global bonds issued by foreign financial institutions, an indicator of foreign demand for YTL-denominated assets, was slightly up in the first quarter of 2008 over a quarter ago, it still was significantly down from the comparable period in previous years. Total bond stock, on the other hand, registered a modest decline from the third quarter of 2007 (Graph 5.1.7).

Graph 5.1.7. YTL Denominated Bonds Issued by Foreign Financial Institutions

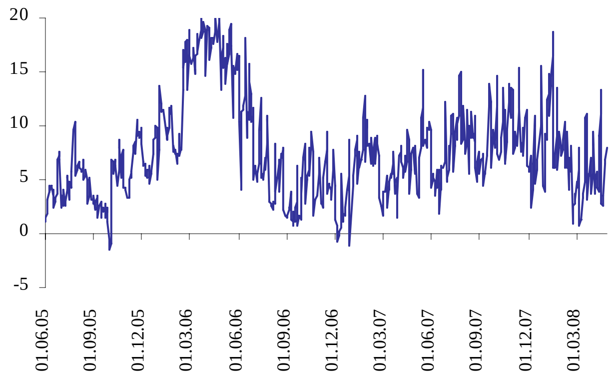


Source: CBRT.

CBRT's net foreign exchange purchase through several auctions amounted to around 3.3 billion US dollars in the first quarter of 2008. CBRT's foreign exchange reserves rose to 75 billion US dollars as of April 18.

Excess liquidity sterilized through the overnight market decreased in the first quarter, driven by the reduced number of foreign exchange purchase auctions, Treasury's reduced net foreign currency borrowing and the growing demand for money (Graph 5.1.8). Excess liquidity is expected to decrease further in the upcoming period, reflecting a modest tightening in monetary conditions.

Graph 5.1.8. Excess YTL Liquidity
(Billion YTL)

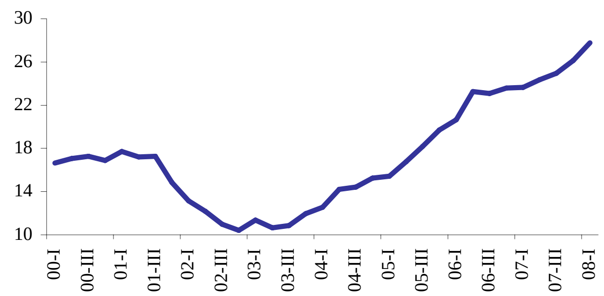


Source: CBRT.

5.2. Financing and Loans

In the first quarter of 2008, consumer loans posted a relative drop, while real sector loans continued to grow. Accordingly, the ratio of total loans to national income expanded further (Graph 5.2.1).

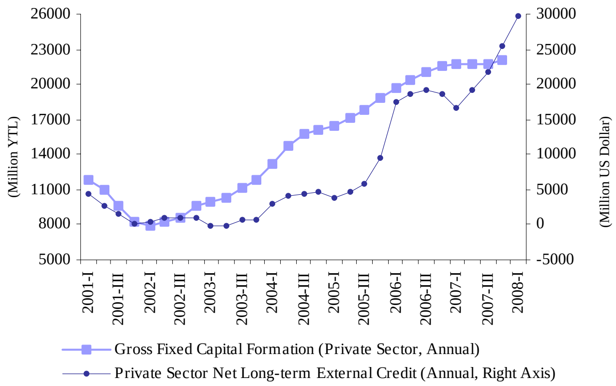
Graph 5.2.1. Real Sector Loans/GDP*
(Percent)



*Real sector loans are composed of consumer loans and business loans. 2008 Q1 GDP shows estimated figures.
Source: CBRT.

The share of foreign currency loans extended to companies by foreign branches of commercial banks in total loans increased in the first quarter. Besides, private sector's long-term foreign borrowing continued to follow an upward trend. In February, private sector's long-term borrowing amounted to 29.6 billion US dollars on net over the past one year. On balance, the growth of real sector loans hardly slowed in the first quarter. Yet, the ongoing global credit crunch poses a risk to real sector's borrowing facilities and thus to the general economic activity.

Graph 5.2.2. Private Sector's Foreign Borrowing and Investments



Source: TURKSTAT, CBRT.

The moderate growth in consumer loans continued into the first quarter of 2008. Housing loans remained on the rise in real terms. Personal loans with higher costs and use of credit cards continued to grow, albeit at a slower pace, whereas automobile loans decreased further in real terms (Table 5.2.1).

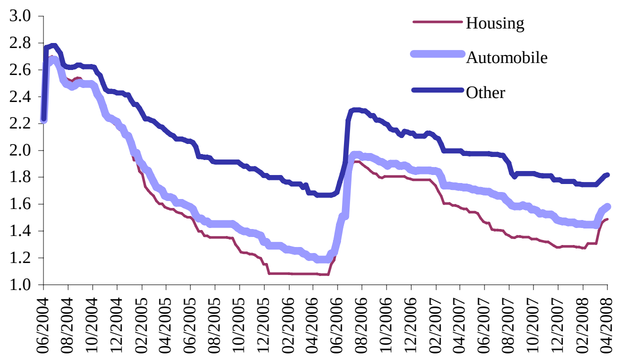
Table 5.2.1. Consumer Loans and Claims from Credit Cards
(Real Quarterly Percentage Change)

	2006	2007				2008
	IV	I	II	III	IV	I
Consumer Loans	3.6	2.6	9.0	10.0	6.6	5.6
Housing Loans	2.2	2.7	7.5	10.2	5.4	6.5
Automobile Loans	-5.0	-8.9	-3.4	-2.0	-1.4	-4.5
Other Loans	8.9	6.6	14.5	12.8	9.9	6.7
Credit Cards	2.1	-1.6	7.7	2.4	3.2	2.2

Source: CBRT.

The reduced ability of commercial banks to provide loans, driven by global financial tensions, restrains credit supply. Moreover, as foreign financial institutions cut down the reissue of their YTL-denominated bonds, commercial banks fail to have access to long-term YTL-denominated loans in swaps (Graph 5.1.7). Besides, the recent slowdown in the expansion of loan syndication and securitization suggests that foreign borrowing facilities have partially decreased. On balance, uncertainties over international markets are likely to decrease credit supply as they prompt commercial banks to cut direct loans and choose a more liquid portfolio.

Graph 5.2.3. Consumer Loan Rates
(Monthly, Percent)



Source: Websites of selected commercial banks.

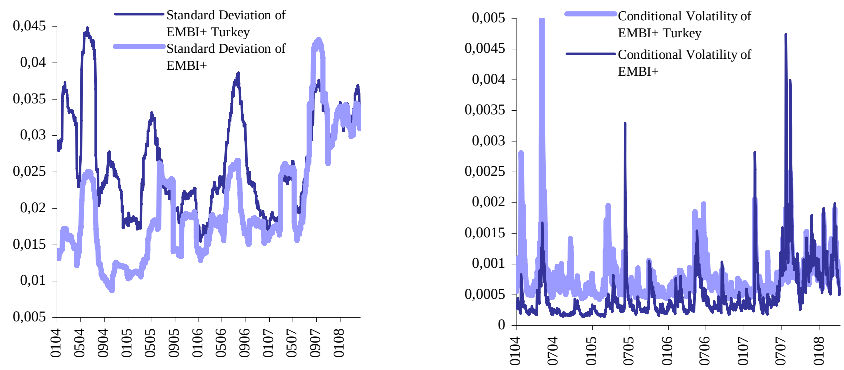
The downtrend in interest rates on consumer loans was replaced by a run-up in the first quarter of 2008 (Graph 5.2.3). As the risk premium increased, banks turned cautious despite policy rate reductions. Accordingly, interest rates on housing, automobile and personal loans went up by 20, 11 and 5 basis points, respectively, from the previous quarter.

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

BOX 5.1. AN OVERVIEW ON RISK PREMIUM VOLATILITY AND RISK APPETITE ELASTICITY IN EMERGING ECONOMIES

The global volatility that started in mid-2007 raised the level and volatility of risk premium in emerging economies (Graph 5.1.1). Previously, the volatility in EMBI+ Turkey index, Turkey's risk premium indicator, was generally higher than the overall EMBI+ index, an indicator of emerging market risk premium, and the difference would become more pronounced in times of global uncertainty (Graph 1). However, despite the continued global uncertainty, the difference between both indexes has recently narrowed down. In fact, the volatility in EMBI+ Turkey index had remained well below that of the overall EMBI+ index until the last period .

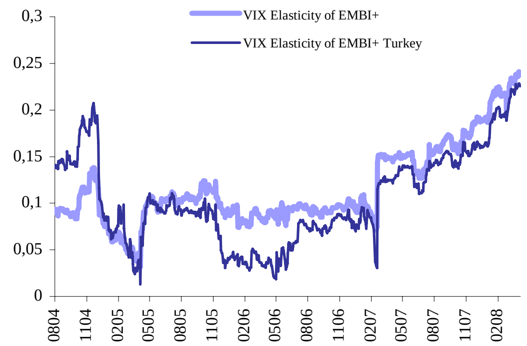
Graph 1. Volatility of Changes in EMBI+ and EMBI+ Turkey Indexes*



*The graph on the left shows the 100-day moving standard deviation of changes in indexes, while the graph on the right shows conditional volatilities of indexes estimated by generalized autoregressive conditional heteroscedastic models.

In addition to increased volatility in EMBI+ and EMBI+ Turkey indexes, the elasticity in the VIX index, an indicator of global risk appetite, also trended upwards following the rise in its level during the second quarter of 2007 (Graph 2).

Graph 2. Risk Appetite Elasticity in Risk Premium*



*Elasticity is estimated by a moving regression approach that uses the rate of changes in EMBI+ and EMBI+ Turkey indexes and the rate of change in the VIX index, an indicator of risk appetite. Moving regressions cover a 150-day period.

6. Public Finance

Given the improved level and structure of public debt stock, the primary surplus/GNP target ratio for 2008 is lowered by 1 percentage point from previous years to 5.5 percent. The success of fiscal policy in the past few years helped significantly reduce inflation expectations and achieve high growth rates. To ensure a long-lasting effect, fiscal stance has to be kept tight and micro-level reforms that help improve the investment climate and boost productivity and competitiveness, such as the social security reform, should be implemented effectively. The global financial downturn and elevated food and energy prices that push up global inflation heightened uncertainties in the world economy. Thus, even if the level and structure of public debt stock are improved in recent periods, increased global uncertainties still necessitate to keep fiscal policy tight.

Aside from the tight fiscal policy, privatization revenues also helped improve debt stock indicators and lower the risk premium. However, as stated above, global uncertainties and an abrupt change in internal dynamics might have an adverse impact on privatization. Therefore, strict adherence to budget targets will curb further spikes in risk premium, help reduce inflation expectations and enhance the effectiveness of monetary policy. Yet, in case the slowdown in economy accelerates further despite strong tax performance in the first quarter, tax revenues may fall beyond expectations in the remainder of the year. Hence, amid a dampened global economic environment, developments in budget expenditures will directly affect the sensitivity of inflation expectations to fiscal policy.

It is of vital importance for effectiveness of monetary policy and managing inflation expectations in line with target that the recent improvement in public-sector institutional infrastructure and governance continues into the upcoming period. Therefore, the reforms to ensure full membership to the EU should be effectively implemented.

Recent information on budget developments indicates that items, such as agricultural subsidies and other purchases of goods and services, contained in central government expenditures increased remarkably in the first quarter of 2008. In contrast, after having exceeded targets in the past few years, health care expenditures went down from the comparable quarter last year, and interest expenditures declined by 13.9 percent. Yet, in spite of a strong central government tax performance during the first quarter of 2008, non-tax revenues dropped sharply compared to a year earlier, resulting in a slower growth of total budget revenues compared to that of total budget expenditures. Despite fears of waning domestic demand, tax revenues increased by 18.6 percent on the back of adjusted indirect tax revenues and enhanced tax collection. Even though some of the abovementioned budget items performed well, the drop in the primary surplus of the central government budget by 25.8 percent in March compared to the same period in 2007 when budget targets were hardly met, and the rise in the budget deficit by 31.2 percent require the careful monitoring of budget developments.

6.1. Budget Developments

In the first quarter of 2008, the central government primary balance and the total budget balance ran a deficit of 9.4 and 4.4 billion New Turkish liras, respectively (Table 6.1). In the same period, revenues and expenditures increased by 2.3 and 4.3 percent, respectively. Interest expenditures decreased by 13.9 percent, limiting the growth of central government budget expenditures.

Non-interest expenditures were 13.0 percent up in the first quarter of 2008 compared to the same period in 2007, largely due to increased current transfers, up 17.9 percent from 2007. The steep rise in support payments and direct income payments for livestock producers caused agricultural subsidies to skyrocket by 103.4 percent. Moreover, support payments for farmers who were hit by severe drought in 2007 were made in the first quarter of 2008. The share of agricultural subsidies in budget expenditures has been on a significant upward trend since 2000 (Graph 6.1.1). The integration of agricultural subsidies into the budget after the financial crisis in 2001 contributed to this upward trend, but it is observed that this upward trend continued in the following years. The direct income support program that was initiated in the post-crisis period is thus planned to be replaced by a product-based support model. The rest of the non-interest expenditure items, other than current transfers, generally changed along with the rise in non-interest budget expenditures, while capital transfers increased by 24.6 percent from the same period in 2007 and capital expenditures decreased by 26.1 percent.

Table 6.1. Central Government Budget Aggregates
(Billion YTL)

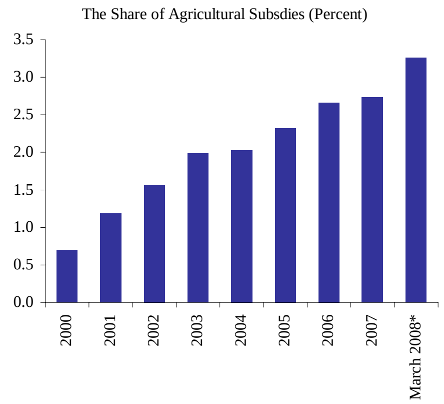
	2007 January-March	2008 January-March	Rate of Increase (Percent)	Realization/ Budget Target (Percent)	2008 Budget Target	2008 Budget Target/GDP*
Central Government Expenditures	**49.44**	**51.56**	**4.3**	**23.2**	**222.6**	**22.8**
A) Interest Expenditures	**15.97**	**13.75**	**-13.9**	**24.6**	**56.0**	**5.7**
B) Non-Interest Expenditures	**33.48**	**37.81**	**13.0**	**22.7**	**166.6**	**17.1**
I. Personnel Expenditures	11.19	12.51	11.8	25.7	48.7	5.0
II. Govt. Premiums to Social Security Agencies	1.41	1.59	12.8	24.8	6.4	0.7
III. Purchase of Goods and Services	3.46	3.78	9.2	16.5	22.9	2.3
IV. Current Transfers	14.86	17.51	17.9	25.3	69.2	7.1
V. Capital Expenditures	1.26	0.93	-26.1	7.9	11.8	1.2
VI. Capital Transfers	0.44	0.55	24.6	26.2	2.1	0.2
Central Government Revenues	**46.11**	**47.19**	**2.3**	**23.1**	**204.6**	**21.0**
A) General Budget Revenues	**45.43**	**45.33**	**-0.2**	**22.7**	**199.4**	**20.4**
I-Tax Revenues	33.94	40.26	18.6	23.5	171.2	17.5
1. Taxes on Income and Profits	10.04	12.82	27.7	24.4	52.6	5.4
2. Taxes on Property	1.39	1.64	18.2	40.6	4.0	0.4
3. Domestic Taxes on Goods and Services	14.22	15.78	10.9	22.1	71.4	7.3
4. Taxes on Intl. Trade and Transactions	6.26	7.73	23.3	23.1	33.5	3.4
II-Non-Tax Revenues	11.49	5.07	-55.8	18.0	28.2	2.9
B) Revenues of Special Budget Administrations	**0.64**	**0.93**	**43.8**	**27.1**	**3.4**	**0.4**
C) Revenues of Regulatory and Supervisory Agencies	**0.03**	**0.93**	**2772.1**	**54.0**	**1.7**	**0.2**
Budget Balance	**-3.33**	**-4.37**	**31.2**	**26.0**	**-18.0**	**-1.8**
Primary Balance	**12.63**	**9.38**	**-25.8**	**26.0**	**38.0**	**3.9**

*GDP is assumed to grow by a nominal 14 percent in 2008.

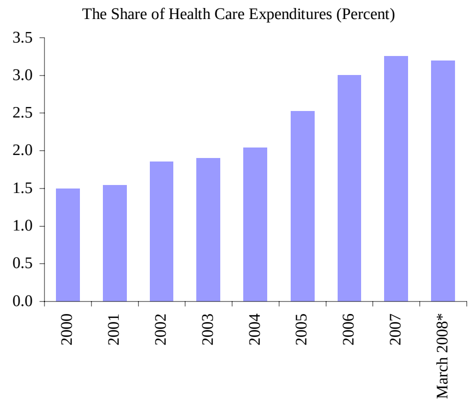
Source: Ministry of Finance.

Health care expenditures classified under goods and services decreased by 3.5 percent in the first quarter of 2008 compared with a year earlier, which is quite remarkable given the fact that health care expenditures have sharply increased their share of budget allocations for the past few years (Graph 6.1.1). The answer to whether this slowdown is temporary or permanent lies in health care expenditures over the remainder of the year.

Graph 6.1.1. Shares of Agricultural Subsidies and of Health Care Expenditures in the Budget



* Annualized
Source: Ministry of Finance.



* Annualized
Source: Ministry of Finance.

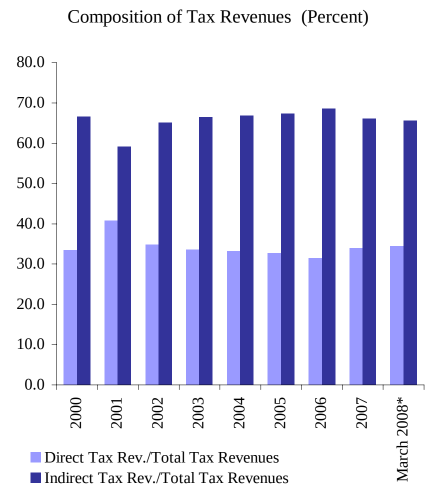
During the January-March 2008 period, non-tax revenues dropped by 55.9 percent compared with the same period in 2007, while tax revenues grew by 18.6 percent. Taxes on wages and profits increased by 27.7 percent, making the largest contribution to the growth in tax revenues. The rise in taxes on wages and profits was mainly driven by strong corporate tax and income tax revenues that rose by 41.7 and 21.6 percent, respectively. Corporate tax revenues grew on the back of the base effect from an unpaid tax amount allowed as a deduction in January 2007 following the corporate tax rate cut in 2006. At the same time, the strong growth in corporate profits in 2007, particularly in commercial banks, and the increased efficiency of tax collection were the main factors behind this positive development.

In 2007, domestic demand waned and therefore consumption-related taxes performed poorly. In the first quarter of 2008, domestic value-added taxes and private consumption taxes were up 9.7 percent from the comparable period in 2007, which, however, still lagged behind the overall rate of increase in tax revenues. Value-added taxes on imports, on the other hand, increased by 23.7 percent in the first quarter, buoyed by the growth in import volume.

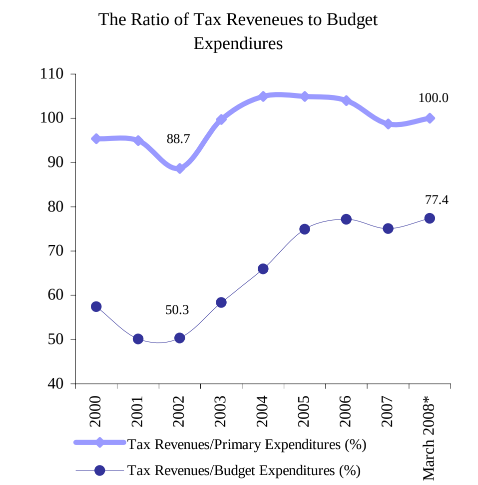
The main driver of the significant drop in non-tax revenues was the base effect from the privatization of Turk Telecom that generated a revenue of 5.8 billion New Turkish liras in March 2007, but even excluding that amount, non-tax revenues would still decrease by a substantial 5.0 percent. In contrast, revenues of special budget administrations and of regulatory and supervisory agencies grew at a solid pace, adding to the growth in central government revenues, albeit at a modest rate.

Recent trends in the composition of tax revenues are another factor to consider in analyzing tax revenues. The share of indirect taxes in tax revenues grew steadily from 2001 to 2007, up to 68.5 percent in 2006 (Graph 6.1.2). But in 2007, indirect taxes suffered a decline in their share due to a slackening domestic demand and a robust foreign demand and a strong corporate tax performance. The downtrend in the share of indirect taxes continued into March 2008. On the other hand, the rate of coverage of budget expenditures by tax revenues rose to 77.4 percent in March 2008, up from 50.3 percent in 2002, thanks to the budgetary discipline maintained in primary expenditures as well as the sharp downturn in interest expenditures.

Graph 6.1.2. The Composition of Tax Revenues and Their Rate of Coverage of Budget Expenditures



*Annualized
Source: Ministry of Finance.



*Annualized
Source: Ministry of Finance.

The consolidated public-sector primary surplus amounted to 29.2 billion New Turkish liras at end-2007, far below the target of 40.7 billion New Turkish liras (Table 6.2). Accordingly, the public-sector primary surplus over national income ratio was around 4 percent, missing the end-2007 target of 6.5 percent. In January 2008, the consolidated public-sector primary balance, excluding SEEs, posted a surplus of 4.1 billion New Turkish liras. As it is known, the public-sector primary surplus/1987-based 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 over the past few years.

Table 6.2. Program-Defined Consolidated Public Sector
(Cumulative, Billion YTL)*

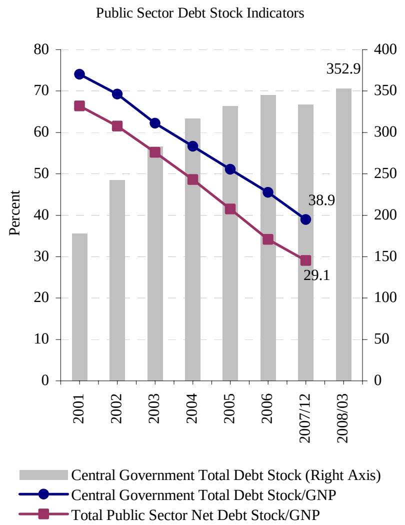
	2005	2006	August-2007	December-2007	January-2008
Realizations					
Primary Balance	**28.3**	**36.2**	**23.1**	**29.2**	**-**
Primary Balance (Excl. SEEs)	**23.6**	**34.6**	**19.8**	**26.7**	**4.1**
Central Govt. Budget	24.1	33.5	16.6	**21.7**	**4.2**
Overall Balance	**-4.2**	**-1.2**	**-6.5**	**-10.0**	**-**
Central Govt. Budget	-11.5	-6.9	-15.1	**-20.7**	**-0.5**
Targets					
Adjusted Program**					
Primary Balance	30.4	34.5	32.3	40.7	-
Primary Balance (Excl. SEEs)	26.7	31.8	31.1	38.2	-
Overall Balance	-19.7	-6.5	-3.6	-5.5	-

* Figures for 2008 are provisional.
** Budget targets set at the turn of the year are revised by selected adjustment items, which are then defined as adjusted program targets.
Note: Consolidated Public Sector = Central Govt. + 23 SEEs + Extra Budgetary Funds (Defense Industry Support Fund, Privatization Fund and Social Assistance and Solidarity Encouragement Fund) + Social Security Agencies + Unemployment Insurance Fund.
Overall Government = Consolidated Public Sector + Local Administrations + Revolving Funds + Non-CGS SEEs
Source: Treasury.

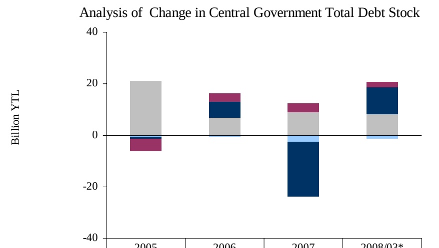
6.2. Developments in Debt Stock

The central government debt stock increased by 5.8 percent to 352.9 billion New Turkish liras in March 2008, compared to 2007, owing to the appreciation in the exchange rate and net domestic debt growth that contributed by YTL 10.5 billion and YTL 8.2 billion, respectively. Meanwhile, the parity effect raised the debt stock by YTL 2.0 billion, while net foreign debt went down by YTL 1.3 billion. Furthermore, the ratio of net total public debt stock to GDP edged down to 29.1 percent at end-2007, maintaining the downward pattern of recent years (Graph 6.2.1).

Graph 6.2.1. Public Debt Stock Indicators
(Billion YTL)



Source: Treasury.



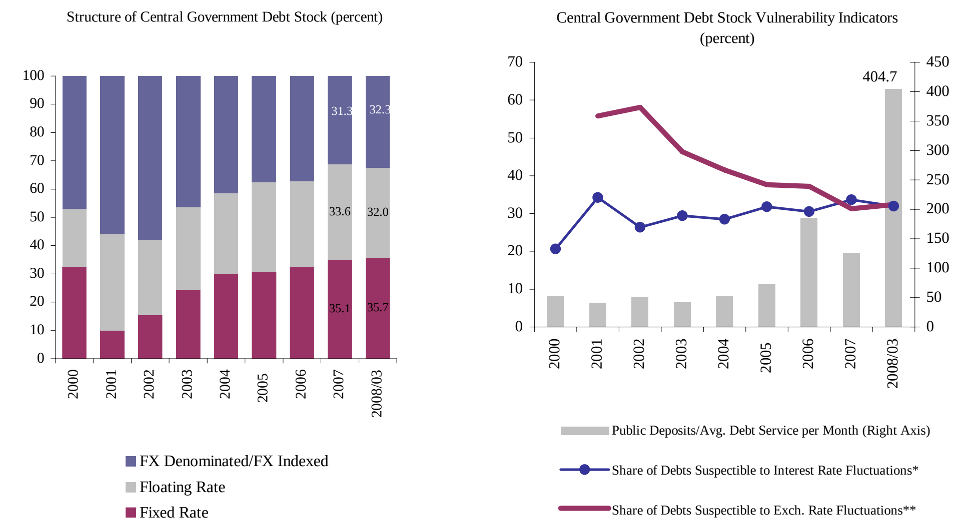
	2005	2006	2007	2008/03*
Parity Effect**	-4.8	3.2	3.4	2
Tot. Exch. Rate Effect***	-0.8	6.4	-21.2	10.5
Net External Borrowing	-0.6	-0.5	-2.6	-1.3
Net Domestic Borrowing	21.1	6.7	8.9	8.2

Changes compared to end-2007.
** Changes arising from movements in USD/EUR and USD/SDR parities.
*** Changes arising from movements in the YTL/USD parity.
Note: Changes in net debt denotes the change adjusted for the exchange rate and parity effect.
Source: Treasury, CBRT.

In the first quarter of 2008, the share of fixed-rate and exchange-rate-indexed instruments in central government debt stock increased compared with end-2007, while the share of floating rate instruments decreased (Graph 6.2.2). The share of exchange-rate-indexed (FX-denominated and FX-indexed) instruments had trended substantially down since 2002, but went up at a strong pace in March 2008, compared to 2007, following the recent weakening of YTL. Moreover, the maturity of the current FX-denominated debt stock is relatively lengthened and the Treasury holds an increased amount of foreign exchange deposits, which altogether mitigates the risks associated with exchange rate volatility on public sector.

The Treasury, as stated in its 2008 Financing Program, plans to make a net YTL 3.9 billion domestic borrowing and YTL 3.4 billion foreign borrowing, totaling YTL 7.3 billion. In addition, the Treasury will not issue any FX-indexed securities in 2008 and will limit the FX-denominated domestic debt rollover ratio to 60 percent. Besides, since the Treasury's domestic borrowing will largely be in fixed-rate instruments, the share of fixed-rate instruments in the central government debt stock will increase.

Graph 6.2.2. Structure of Central Government Debt Stock

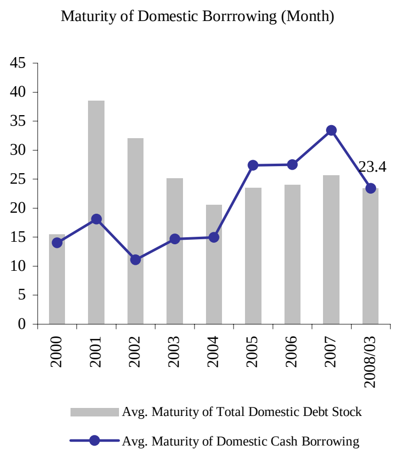


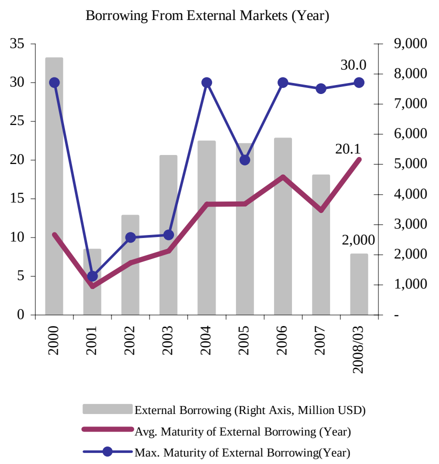
* Debt stock sensitive to interest rates contains discounted securities with a maturity less than 1 year and government securities with flexible interest rates.
** Debt stock sensitive to exchange rates contains foreign debt stock and FX-denominated and FX-indexed domestic debt stock.
Source: Treasury, CBRT.

In line with the financing strategy intended for reducing the liquidity risk, the ratio of public deposits to average monthly debt service ended March 2008 at a dramatic 404.7 percent (Graph 6.2.2). The Treasury is expected to maintain its policy of holding large reserves in 2008, which is considered to be helpful in reducing the upward trend in risk perceptions driven by potential problems in global credit markets.

The average maturity of domestic cash borrowing equaled 23.4 months in the first quarter of 2008, down from 2007. Likewise, the average maturity of total domestic debt stock also fell to 23.4 months in March 2008. Moreover, bond issues yielded a USD 2.0 billion worth of long-term foreign debt in March 2008 with an average maturity of 20.1 years (Graph 6.2.3).

Graph 6.2.3. Maturity of Borrowing from Domestic and Foreign Markets





Source: Treasury, CBRT.

7. Medium Term Projections

In this chapter, our revised assumptions for fundamental macroeconomic variables are summarized and relating medium-term inflation and output gap forecasts are presented. Unlike previous inflation reports, we develop two alternative scenarios that examine our assumptions on supply shocks from either a more optimistic or a more pessimistic view and share our resulting inflation and output gap forecasts. In the last part, we give a brief account of the potential risks that might cause our baseline-scenario forecasts to deviate significantly. Considering the current economic conjuncture, forecasts in this Report cover the next three years.

7.1. Current Economic State, 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. These assumptions are revised based on the data released after the January 2008 Inflation Report and compiled from the general outlook, analyses and expert judgments presented in previous chapters.

The fourth-quarter growth figures have broadly matched our forecasts in the January 2008 Inflation Report. The domestic private consumption and investment demand shifted towards imported goods in the final quarter of 2007, while the demand for domestic goods and services waned.

The solid pickup in economic activity during the fourth quarter of 2007 does not seem to be of a long-lasting nature due to excess inventory, global economic slowdown and increased uncertainties. Indeed, first-quarter indicators suggest that production remained unchanged on a quarterly basis. Yet, leading indicators for consumption and investment demand point to a quarterly slowdown in economic activity. Spillovers from the global credit crunch are expected to continue to restrain economic activity and employment in the upcoming period.

Government spending made a modest contribution to growth in the last quarter of 2007. We have developed our forecasts based on public-sector budget targets, and assumed that government spending will have a reduced contribution to total demand in 2008. Our projections for inflation and output gap are produced within this context.

The revision in national accounts in early 2008 hardly changed the trend in growth and led to a limited upward revision in our output gap forecasts. However, this revision did not change the inflation outlook significantly. Therefore, our forecasts are based on the assumption that demand and capacity conditions continue to support the disinflation process.

Developments that are outside the control of monetary policy, such as elevated commodity prices and increased global uncertainty, have put pressure on the overall pricing behavior, thus deteriorating inflation expectations. Besides, the recent increase in risk premium has driven market rates higher.

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

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

In view of current demand conditions, recent exchange rate changes are likely to have a limited impact on the overall pricing behavior. Yet, provided that exchange rates remain stable at about their present level, they will still add around 1.5 to 2 percentage points to the end-2008 inflation and around 1 percentage point to the end-2009 inflation.

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 the risk premium. Our assumptions related to the euro area are derived from the April 2008 release of "Consensus Forecast" results. On balance, our euro area growth forecasts are revised downward while inflation forecasts are revised upward, compared to the previous Inflation Report period. Accordingly, economic growth and inflation in the euro area are expected to be around 1.3 and 2.1 percent, respectively, in 2008. In addition to euro area, estimates for other developed economies and changes in international liquidity conditions are also involved in developing the forecasts.

7.2. Medium-Term Outlook

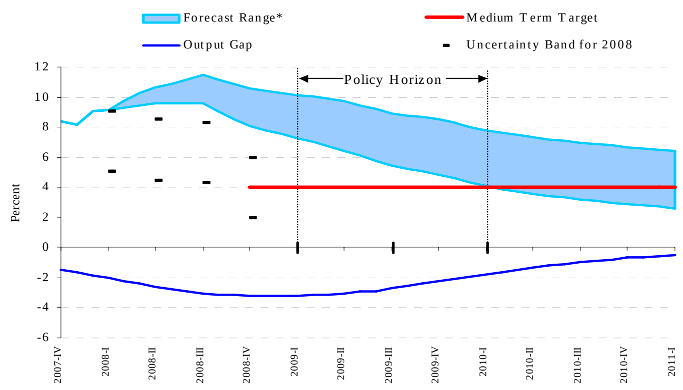
This part, firstly, presents our baseline-scenario forecasts that are developed within the framework of the abovementioned assumptions and projections. Furthermore, we propose two alternative scenarios using optimistic and pessimistic assumptions due to soaring food and energy prices and increased global uncertainties and present our resulting inflation and output gap forecasts.

7.2.1. Baseline Scenario

In view of the above assumptions, we now forecast inflation to be around 9.3 percent at the end of 2008. Our forecasts suggest, with 70 percent probability, that, under the assumption of a gradual and measured tightening towards mid-2008 and constant policy rates thereafter, inflation will be between 4.9 and 8.5 percent (mid point 6.7 percent) at the end of 2009 (Graph 7.2.1.1). Assuming a gradual moderation in food inflation, headline inflation is expected to decelerate to 4.9 percent at the end of 2010 and to 4 percent by mid-2011. We expect non-food inflation to be lower than these figures.

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. Therefore, it should be emphasized that any new data or information on the inflation outlook may lead to a change in our policy stance.

Graph 7.2.1.1. Inflation and Output Gap Forecasts



* The 70 percent confidence interval for the inflation forecast.

The slowdown in economic activity observed for the past one and a half years is expected to continue into the upcoming period due to mounting concerns over a global slowdown. Output gap forecasts that are developed under these assumptions and a tighter monetary stance suggest that total demand conditions will add to their support for the disinflation process over 2008 (Graph 7.2.1.1).

In sum, supply shocks have turned out to be more persistent than expected, increasing the risks of second round effects and necessitating a significant upward revision in our inflation forecasts. Available data indicate that ensuring a steady decline in inflation will require the maintenance of tight monetary policy for an extended period, in which case it still takes more than two years to reach the 4 percent medium-term inflation target.

7.2.2. Alternative Scenarios

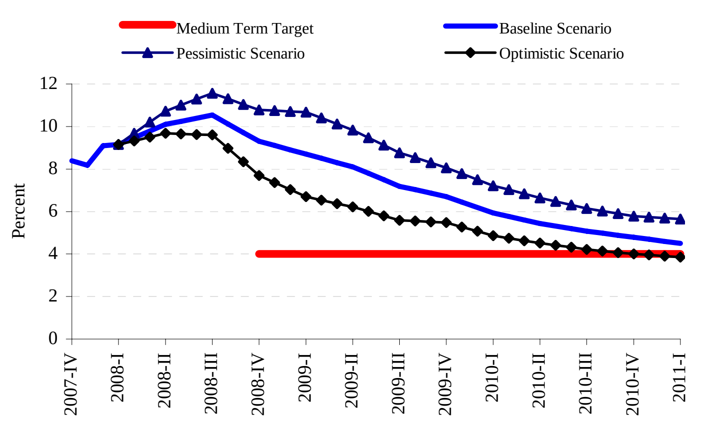
Changes in food, oil and other commodity prices put pressure on inflation in Turkey, as in the rest of the world, and require an upward revision in inflation forecasts. In other words, our forecasts deviate largely due to unforeseen developments that are outside the control of monetary policy. For instance, we had forecast in our October 2006 Inflation Report that inflation would be around 4 percent at the end of the first quarter in 2008. We had developed that forecast based on the assumption that oil prices would remain around USD 60 per barrel and food prices would see a steady correction and follow a similar pattern to inflation in the medium term. However, oil prices have continued to climb thus far and stood around USD 100 per barrel in the first quarter of 2008, while annual food price inflation soared to 13.4 percent in March.

Uncertainties surrounding oil and agricultural commodity prices remain. Taking into account that our revised forecasts are based on quite conservative assumptions, downside risks, especially on food and energy prices, are as significant as upside risks. Therefore, in order to maintain a healthier assessment base for the inflation outlook and monetary policy, we find it helpful to publicize our alternative projections that are developed under different scenarios for food and oil prices.

Our pessimistic scenario assumes food inflation to materialize at 17, 11 and 10 percent, respectively, in 2008, 2009 and 2010, and oil prices to surge up to USD 150 per barrel at the end of 2009. Under this scenario, assuming that short-term policy rates are increased gradually until the end of 2008, inflation amounts to 8.1 percent by the end of 2009 and to 5.8 percent by the end of 2010 (Graph 7.2.2.1).

Our optimistic scenario assumes that food inflation materializes at 9, 5 and 4 percent, respectively, in 2008, 2009 and 2010, and oil prices ease to USD 85 per barrel at the end of 2009. Under this scenario, assuming a limited rate hike in the upcoming months and gradual cuts starting from the last quarter of 2008, inflation is forecast to be 5.5 percent by the end of 2009 and 4 percent by the end of 2010 (Graph 7.2.2.1).

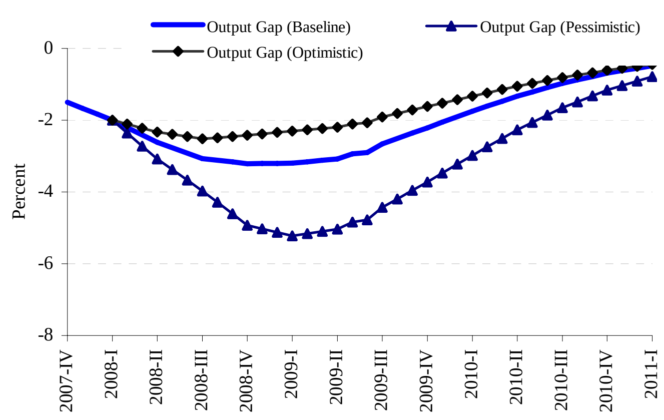
Graph 7.2.2.1. Inflation Forecasts; Baseline Scenario and Alternative Scenarios



All in all, our revised projections indicate that, even under an optimistic scenario, inflation may be over 4 percent for the two years ahead.

Our output gap forecasts under both scenarios are shown in Graph 7.2.2.2.

Graph 7.2.2.2. Output Gap Forecasts; Baseline Scenario and Alternative Scenarios



7.3. Risks

A protracted period of rising food and energy prices has led to a significant overshooting of the inflation targets since the adoption of the inflation targeting regime and consequently increased the stickiness in inflation expectations, as economic agents have become more backward looking. Under normal conditions, supply shocks are expected to alter relative prices rather than the underlying inflation trend. Nevertheless, the fact that several long-lasting shocks appeared concurrently has increased the risks to the price setting behavior. The recent pickup in inflation expectations therefore requires a monetary policy response. In this respect, recent developments in the pricing behavior and the underlying inflation trends are of particular concern. Thus, it may be necessary to pursue a tighter monetary policy than that envisaged in our baseline, should the price setting behavior deteriorate even further.

Another major risk to the inflation outlook is a sharper-than-expected slowdown in the global economic activity, which, in turn, could lead to further volatility in financial markets. The final impact of the US subprime meltdown and of its spillovers into money and capital markets is yet to be seen. These uncertainties have been dampening the risk appetite and thus slowing the capital flows to emerging economies. The CBRT will not react to temporary fluctuations in financial markets, unless they threaten the medium-term disinflation, but will not hesitate to tighten monetary policy in case of a significant worsening in the overall pricing behavior.

Finally, our medium-term projections assume no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanism. In particular, this means that a necessary tightening in the fiscal balance would largely occur through expenditure cuts and not higher excise taxes. Any deviation from this may have an effect on the outlook for inflation and monetary policy.

7.4. Conclusion

Emerging risks on food and energy prices suggest that converging to the 4 percent medium term inflation target may take a considerable amount of time. Besides, exchange rate changes, resulting from the ongoing uncertainty surrounding the global economy, have the potential to further restrain disinflation. Accordingly, the CBRT envisages a framework in which it takes more than two years to reach the 4 percent inflation target.

Such an approach does not mean that monetary policy will be looser in the forthcoming period. On the contrary, our inflation forecasts presented above are built on a gradual and measured tightening of monetary policy in the period ahead. Moreover, our monetary policy will be more responsive to bad news than good news. This approach reflects our firm commitment to attaining price stability.

Prudent monetary policy is a necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical on the road to price stability. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance productivity, are monitored closely by the CBRT with regard to their implications on macroeconomic and price stability.

GRAPHS

TABLES

ABBREVIATIONS

ABCP	Asset Based Commercial Paper
AMA	Automotive Manufacturers Association
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
EU	European Union
EUROSTAT	Statistical Office of the European Communities
Fed	Federal Reserve Bank of America
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
LME	London Metal Exchange
LIBOR	London Interbank Offered Rate
MSCI	Morgan Stanley Capital Index
OECD	Organization for Economic Co-Operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PBC	People's Bank of China
PCDF	Primary Dealer Credit Facility
PMI	Purchasing Managers Index
SCA	Special CPI Aggregates
SCT	Special Consumption Tax
SNB	Swiss National Bank
SPO	State Planning Organization
TAF	Term Auction Facility
TEA	Turkish Exporters' Assembly
TURKSTAT	Turkish Statistical Institution
TSLF	Term Securities Lending Facility
USA	United States of America
VAT	Value Added Tax
WGMA	White Goods Manufacturers Association
WASDE	World Agricultural Supply and Demand Estimates
YTL	New Turkish lira