No: 2006-27

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SUMMARY OF THE MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 7 June 2006

Inflation Developments

1. Inflation pursued its upward trend in May and reached 9.86 percent. The exchange rate movements arising from recent fluctuations in financial markets have started to affect prices through the cost channel. It is estimated that the pass-through effect of exchange rates on May inflation, especially through increments in prices of items like petroleum products, electrical appliances, package tours abroad and gold, was approximately 0.65 percentage point**.**

2. Unprocessed food prices continued to increase and affected inflation adversely in May, with a rise of 1.33 percent. Especially the rate of increase recorded in fruits (30.97 percent) was considerably above the past seasonal patterns. Annual price increases in processed foods are rather lower and more stable compared to those of unprocessed foods, which might indicate that the price increases in food prices are supply-driven. Prices of unprocessed foods, which usually decrease in summer, have the potential to positively affect inflation in June and July. Nevertheless, it is anticipated that the annual rise in prices of unprocessed foods is likely to continue above the general inflation trend for a while. Meanwhile, the monthly increase of 10.88 percent in clothing and footwear, which was mostly attributed to seasonal factors, was another determinant of May inflation.

3. The effects of exchange rate developments are both faster and higher on producer prices than they are on consumer prices. Actually, producer prices responded very quickly to these developments in May where the annual inflation increased rapidly. It is projected that the upward trend will continue in June, as well. It should be reiterated that there is no policy target designated for producer prices.

Factors Affecting Inflation

4. Recently published data show that supply and demand developments are consistent with the projections presented in the Inflation Report of April. The investment tendency has remained strong; the revival in demand has continued without acceleration; and output performance has been robust.

5. However, the outlook needs to be revised in light of the latest developments. Due to recent changes in international liquidity conditions, emerging markets, including Turkey have been adversely affected and fluctuations have been experienced in financial markets. Such a development can be attributed to expectations that developed countries would continue to tighten their monetary policies in response to inflationary pressures arising from rapid expansion of global output. As this development occurred at a time when the current account deficit widened and coincided with other perceptions of domestic uncertainty, the Turkish economy was affected more seriously than other developing countries. For a better comprehension of monetary policy decisions, the potential impacts of these factors on the inflation outlook should be evaluated.

6. Domestic demand, which has been high for quite a while, is expected to slow down in the months ahead. Price increases in imported goods, rise in interest rates, and increased volatility in financial markets would decelerate both consumption and investment demand in the short run. With these developments, imports of consumption and investment goods would decrease. However, it is projected that the slow-down in imports of intermediary goods would be limited due to the high level of crude oil prices and the related structural factors.

7. Even if the volatility in exchange rates curbs domestic demand in the short-run, exchange rates would not have an adverse impact on growth in the medium-term due to the rise in net foreign demand. However, the recent developments are not confined to fluctuations in exchange rates. It is expected that the slowdown in domestic demand, arising from the rise in loan rates, shortened maturities, decreased consumer confidence and increased foreign financing costs, would be more pronounced than the increase in foreign demand. In other words, the probability of demand-pulled inflation has decreased for the upcoming period.

8. The slowdown tendency in the rise of commodity prices can be seen as a favorable development for future inflation. The upward pressure on commodity prices has become more limited as global risk appetite decreases. Moreover, the increasingly intensifying international competition is expected to restrict the prices of most imported inputs in the upcoming period.

9. It is anticipated that unit labor costs, which bear significance as to inflation, will remain at low levels in the medium term. The rapid increases in investments during the last three years will continue to induce further productivity. Furthermore, the ongoing upward trend of the labor force participation, which is caused by structural factors, continues to be a factor that restrains labor costs. In conclusion, it is expected that unit labor costs, which are crucial for price dynamics, will support the decline in inflation in the medium term.

Outlook and Monetary Policy

January-April 2006

10. First of all, it is necessary to remember the period prior to May 2006. The Central Bank had previously forecasted that the increase in annual inflation in the first four months of 2006 would not disrupt the medium-term inflation dynamics. Even the high inflation figures in April did not change this view. In April, the number of products whose prices increased in the CPI basket was lower compared to the same period of the previous year. This was indicating that the increase in inflation mainly stemmed from the temporary price increases in some sub-items rather than the deterioration of general pricing behavior. Indeed, when the sub-items are analyzed, it is seen that the factors that affected inflation in the first four months of the year were generally beyond the control of monetary policy. Consequently, monetary policy was not tightened against the shocks related to tax adjustments, oil prices, gold prices and prices of unprocessed food, which generally originate from supply conditions and are of a temporary nature. Although annual inflation increased in this period, medium-term expectations did not deteriorate, in a manner confirming the consistency of the maintained policy path.

May 2006 and Onwards

11. However, international liquidity conditions began changing from May onwards, due to the flow of funds from developing countries to developed markets that are perceived to be safer. In this way, one of the significant risks mentioned in the Inflation Report has materialized and there appeared the need to re-assess inflation outlook and monetary policy stance.

12. Given the recent financial market fluctuations, the annual inflation figures to be recorded in the next months might further go up temporarily, with the pass-through effect of the exchange rate movements. The Monetary Policy Committee has deemed it necessary, on 7 June 2006, to revise the policy rates in order not to let such temporary developments cause permanent effects on the medium-term expectations and pricing behaviors, and also to make sure that the medium-term inflation trend is kept in line with the targets.

13. It is expected that the rise in annual inflation will continue in June and July and inflation will remain above the 2006 year-end target. The *direct* effect of exchange rates on inflation will mainly be observed in June. Although the downward trend of crude oil and gold prices will partially limit the effect of exchange rates on petroleum and gold prices, annual inflation will rise in June, as well. In July, the direct effects of exchange rates on inflation will continue with a gradual decline. The rise in annual inflation might also continue. The direct effects are expected to decrease remarkably from August onwards. Given the currently available information and considering that the base effect caused by the tax levied on tobacco products in 2005 will reduce annual inflation by one percentage point, it is estimated that the annual inflation figures of August will be lower than those of July.

14. In fall 2006, demand conditions are expected to be the main determinant of price dynamics. In light of available data, the analysis made in the previous part does not foresee an inflationary pressure originating from domestic demand in the upcoming period. In this respect, it is considered that the indirect effects of the volatility in exchange rates on inflation will remain modest along with the slow-down in domestic demand, and will not reflect upon 2007. Under the main scenario where monetary policy adopts a cautious stance, expectations are well-managed and fiscal policy is conducted consistently with the inflation target, it is foreseen that inflation will display again a downward trend in the medium term and converge to the point-target set for end-year 2007.

15. In consideration of these evaluations, the Monetary Policy Committee has decided to increase the policy rates by 1.75 points. In light of currently available information, the policy rates are less likely to rise in the short-term, compared to the previous period. However, it should be reminded that the direction of monetary policy decisions might change conditional on developments pertaining to inflation outlook. Policy decisions will be based on a perspective in which inflation would converge to the target towards the end of 2007. Therefore, accompanied by the envisioned decline in inflation, the direction of policy rates would be downward as well in the medium-term.

16. In the coming period, the Central Bank will continue to closely monitor the factors affecting the inflation outlook as well as the developments in international liquidity conditions. In this context, policy instruments will be used effectively to achieve the medium-term inflation targets.

Risks and Policy Alternatives

17. Decisive steps have been taken towards macroeconomic stability in the last few years. Significant achievements were made in areas of fiscal discipline and financial deepening, which are the prerequisites for the implementation of a sound monetary policy. This enables the Central Bank to utilize short-term interest rates, the main policy instrument in the inflation-targeting regime, efficiently. There is no doubt that there exist some uncertainties regarding the rate and magnitude of the channels through which monetary policy affects inflation. However, such uncertainties are not peculiar to Turkey; the central banks in developed countries also face the same uncertainties. Nevertheless, with regard to the impact of monetary policy on inflation, it can be stated that pursuing tight monetary policy in an economy where there is no fiscal dominance decreases the demand and cost-pushed inflationary pressures in the medium-term. The recent decision of the Monetary Policy Committee should only be evaluated within this framework.

18. Despite the determined stance of monetary policy, there are some risks regarding the inflation outlook in the medium-term. The tightening process of the monetary policies of The Federal Reserve, European Central Bank and the Bank of Japan still continues. In consideration of the available information, it is not possible to say that the uncertainties related to the global liquidity conditions have been entirely disappeared. In case the global risk appetite declines further and the outflow of funds in emerging markets accelerates in the upcoming period, the Central Bank will not hesitate to give the necessary policy response in order to control the medium-term inflation expectations.

19. Pricing behaviors have been changing in recent years, thanks to the reduced inflation rate, the floating exchange rate regime, increased competition and economic policies focused on stability. In the last four years, thanks to the increased confidence in economic policies, inflation targets have become a variable that is increasingly referred to in pricing decisions. The reversal of this tendency stands as one of the significant risks for the upcoming period. It is observed that the medium-term perspective has not yet become prevalent in the economy, due to habits inherited from the past periods of high inflation, and thus, the short-term developments still have the potential to cause permanent impacts on inflation expectations. In this context, the issue of expectations management is still of great importance. Currently, inflation expectations for next year and the following year are 6.66 percent and 5.37 percent, respectively. In other words, economic agents anticipate that the downward trend in inflation will continue in the medium-term but they also expect inflation to be above the path consistent with the targets. In the upcoming period, the impact of the rising tendency of the expectations on pricing behaviors will be cautiously monitored.

20. It should be kept in mind that price stability is a *sine qua non* for sustainable growth. Therefore, the Central Bank will maintain its cautious stance until the price stability perception is firmly established within the economy. Much has been achieved on the way to macroeconomic stability in recent years. The implementation of prudent macroeconomic policies played a significant role in these achievements. The environment of stability should continue in order to avoid a reversal in gains achieved and to keep worries about risk perception limited. In a period where the global risk perception tends to rise, avoiding any implementation that would deteriorate the expectations is of critical importance. In this framework, the continuation of the adaptation and convergence process to the European Union and the uninterrupted implementation of the structural reforms related to our economic reform program, as planned, are crucial. The continuation of the determined steps taken in recent years towards the above-mentioned reforms in the upcoming period will help us to overcome the changes in international conjuncture with minimum fluctuation.