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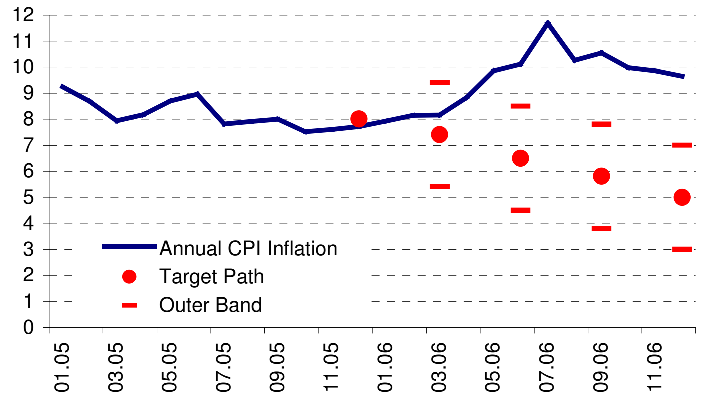
The Central Bank of Turkey (CBT) adopted a formal inflation-targeting framework at the beginning of 2006. Accordingly, the end-year inflation target for 2006 was set as 5 percent, measured by the annual change in the Consumer Price Index (CPI). To facilitate the accountability principle, the CBT has disclosed a quarterly path for 2006 inflation, consistent with the end-year target with an uncertainty band of 2 percentage points on both sides. In adherence with the Article 42 of the Central Bank law, the CBT committed to provide the Government with a written statement explaining the reasons for inflation exceeding the upper limit of the uncertainty band and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits.

The annual CPI inflation outturn by the end of December 2006 was 9.65, breaching the upper limit of the uncertainty band announced for end-2006 at 7 percent (Figure 1). This open letter explains the reasons why inflation exceeded the target by a large margin, evaluates the measures taken by the Central Bank of Turkey to bring inflation back to the target, and finally presents the medium term outlook and the horizon in which inflation converges to the target. As mentioned in our policy statement titled “General Framework of Inflation Targeting and Monetary and Exchange Rate Policy for 2006” published in December 2005, this Open Letter will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual Inflation and Target Path



Source: TURKSTAT, CBT

The Reasons For Exceeding The Target

The reasons for exceeding the target in year 2006 can be identified by decomposing the year into pre- and post-May periods. As explained in the Open Letter published in July 2006, the rise in inflation in the pre-May period can be attributed to a combination of several supply shocks such as rising oil prices, high unprocessed food price inflation, and the sustained increases in the gold prices. Although the relatively strong course of the domestic demand might have been one of the factors affecting inflation, a careful analysis of the price data and capacity indicators suggested that the role of the supply factors in breaching the target, by and large, was dominant in this period.

Inflation dynamics in the post-May period was mainly driven by the exchange rate pass-through effects of the portfolio shock originated from the change in the global risk perceptions. The New Turkish Lira (YTL) has shown a tendency to strengthen since August, yet the domestic currency in the second half of the year remained significantly weaker than the pre-May period. Cumulative exchange rate pass-through since May has added around 3.5 percentage points to the headline inflation—in line with our projections laid out in the June Open Letter. The accumulated impact of the pass-through has kept the annual inflation at high levels. The annual inflation in the unprocessed food and energy prices showed signs of easing in the second half of the year. Although unprocessed food price annual inflation declined to 13 percent by the end of December from its peak of 21 percent on June, it still remains at high levels. Consequently, year-end inflation turned out to be significantly higher than the 5 percent end-year target.

A close look at the last couple of years' annual inflation in certain subgroups of the CPI reveals the main factors behind the rise in inflation in 2006. Figure 2 depicts the dominant role of the unprocessed food prices. High inflation in "goods excluding energy and unprocessed food" can be largely explained by the exchange rate movements. The services inflation, on the other hand, exhibited a gradually declining pattern, confirming that supply side shocks were mainly responsible from the rise in inflation in 2006.[1]

[1] Although inflation in services prices has come down in 2006, its contribution on headline inflation appears to have gone up. This is mainly because of the increasing weight of services in the CPI.

Figure 2: Annual Inflation in Selected Subcomponents of CPI

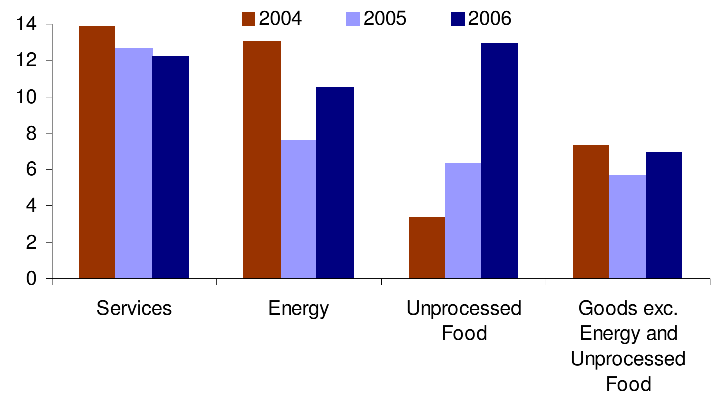


Table 1: Contribution to Annual CPI Inflation

	Services	Energy	Unprocessed Food	Goods exc. Energy and Unprocessed Food
2004	3.58	1.94	0.44	3.40
2005	3.22	1.10	0.79	2.60
2006	3.33	1.51	1.65	3.16

Source: TURKSTAT, CBRT

Annual change in the most widely cited core CPI (excluding energy, unprocessed food, tobacco-alcohol and gold), denoted by H reached 8.9 percent at the end of the year 2006. It should be noted that since a big fraction of the H index consists of durable goods, this index is highly sensitive to exchange rate movements. In that sense, the rise in inflation measured by the H index was identified as a temporary relative price change rather than a movement in trend inflation. First round effects of the exchange rate pass-through, which is more significant in durable goods price inflation, is completed. Indeed, in many of the sub-groups of the durable goods, cumulative pass-through started coming down in the last two months of the year (Table 2).

Table 2: Exchange Rate Pass-through to Durables in the post- May period

	Cumulative Percentage Change Since April 2006							
	May 2006	June 2006	July 2006	August 2006	September 2006	October 2006	November 2006	December 2006
Exchange Rate Basket (0.5Euro+0.5USD)	8.70	21.99	18.86	12.68	13.12	12.83	12.08	11.86
Durable Goods (exc. Gold)	1.82	4.85	7.20	7.70	7.82	8.08	6.90	5.45
Electrical and Non-Electrical Home App.	4.51	5.88	7.65	6.57	5.30	4.48	3.89	2.94
Automobile	1.50	6.60	10.05	10.56	9.33	11.15	10.71	6.85
Furniture	-0.53	2.49	4.65	7.55	11.93	11.95	8.38	8.38
Other Durable Goods	-1.53	0.45	1.61	2.25	1.89	1.30	1.14	2.82

Source: TURKSTAT, CBT.

Measures Taken to Ensure the Convergence of Inflation to the Targets

The volatility in the exchange rates in May and June, coupled with other cost-push factors such as strong commodity prices and rising food prices, has led to a serious deterioration in inflation expectations. Central Bank of Turkey implemented a two-pillar package as a reaction to the volatility in the financial markets and the consequent rise in inflation expectations. The first pillar of the policy response was a rate hike of 400 percentage points in June, which sent the markets a clear signal of the Central Bank's commitment to the medium-term inflation targets.

The second pillar of the package was to withdraw the excess domestic currency liquidity in the financial markets via deposit purchase auctions and FX sales, while raising the lending rate up by a total of 6 percentage points. By doing so, the CBT aimed to reduce the potential volatility in the markets by designing a flexible mechanism to deal with sudden shifts in the market sentiment. The plan worked well and the financial markets calmed down. Markets reacted favorably to all these decisive policy measures and the long-end of the yield curve shifted down.

In the following meeting held on July 20th, the Monetary Policy Committee (MPC) raised the policy rates by a further 25 basis points and stated that a measured tightening might be necessary to meet 2007 end-year target. By giving such a signal, the CBT aimed at containing the second round effects of the exchange rate pass-through and eliminating the gap between inflation expectations and the medium-term targets.

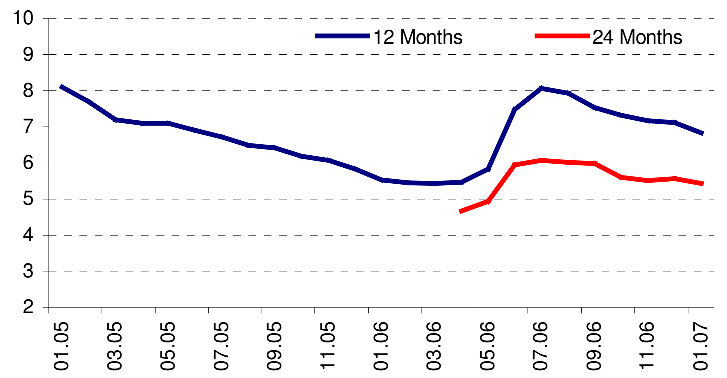
In the rest of the year, the risks of high inflation in the industrial countries have eased, decreasing the uncertainty over the global liquidity conditions. The Federal Reserve's decision to keep rates on hold has further mitigated the impact of the May-June sell-off on the domestic markets. Another positive development was the decline in commodity prices and the signs of a partial "correction" in unprocessed food prices. Nevertheless, the MPC assessed that these developments would not be significant enough to change the medium term inflation outlook, since there was still a considerable amount of uncertainty surrounding the food and the commodity prices, as well as the global liquidity conditions.

In the meanwhile, the third quarter GDP figures have pointed to a significant slowdown in the private consumption demand. However, the decline in the overall growth rate, as it was anticipated in the October Inflation Report, was less pronounced owing to the increase in government spending and the strong course of the external demand. Given that the underlying inflation was significantly higher than the medium term targets, and noting the prevailing uncertainties over the impact of the large June-July interest rate hikes, the MPC decided to keep rates on hold in the last 6 consecutive MPC meetings (Table 3). Moreover, the MPC stressed the need to maintain the tight policy stance in the face of continued global imbalances, high inflation expectations, and the risks related to services inflation.

Table 3 Monetary Policy Committee (MPC) Decisions		
Dates for MPC Meeting	**Decision on Interest Rate**	**Interest Rate**
January 23rd, 2006	No Change	13.50
February 23rd, 2006	No Change	13.50
March 23rd, 2006	No Change	13.50
April 27th, 2006	-0.25	13.25
May 25th, 2006	No Change	13.25
June 7th, 2006(1)	+1.75	15.00
June 20th, 2006	No Change	15.00
June 25th, 2006(1)	+2.25	17.25
July 20th, 2006	+0.25	17.50
August 24th, 2006	No Change	17.50
September 26th, 2006	No Change	17.50
October 19th, 2006	No Change	17.50
November 23rd, 2006	No Change	17.50
December 21st, 2006	No Change	17.50
January 16th, 2007	No Change	17.50
(1) Intermediate		

The decisive policy measures taken by the CBT and the demonstration of its firm commitment to the medium term targets helped to contain the inflation expectations. The deterioration in medium-term expectations stopped in July. Both the 12-month and the 24-month ahead inflation expectations exhibited a declining pattern since then (Figure 3). However, the improvement in expectations was limited, possibly owing to the adaptive behavior of agents coupled with the elevated headline inflation figures. We forecast the inflation expectations to come down gradually as inflation decelerates in the medium term. The fact that currently 24-month ahead inflation expectations are significantly higher than our medium term target of 4 percent, however, necessitates a cautious policy stance.

Figure 3: Inflation Expectations for the Next 12 and 24 Months*



(*): 24 months expectations is available from May 2006 onwards.
Source: CBT

Outlook For Inflation and Monetary Policy

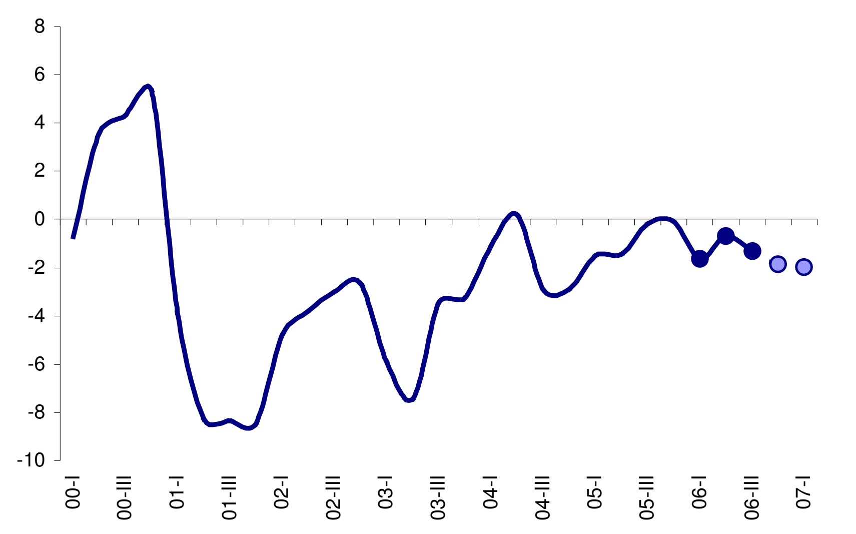
Recent Trends in Inflation

Short-term inflation developments were largely in line with our projections presented in the July and October Inflation Reports. Having reached its peak at 11.69 percent in July, annual inflation has declined gradually. The 2006 end-year inflation turned out to be 9.65 percent, which is very close to the midpoints of the end-2006 forecasts presented in the July Inflation Report (9.85), and October Inflation Report (9.9). Recent decline in inflation can be partly attributed to the easing energy and unprocessed food prices; however, it should be also noted that the core-goods inflation (goods excluding unprocessed food and energy) started to decline as well. The services inflation, on the other hand, displayed more persistence. Currently, the annual percentage growth in services prices is around 12 percent. Although our projections point that the services price inflation will decline gradually; the backward-looking pricing behavior, Balassa-Samuelson effect, and the recent high wage awards are likely to continue to keep services inflation at high levels. Our projections point that the contribution of services inflation to the 2007 headline inflation may slightly exceed 2.5 percentage points.

Current State of the Economy

The macroeconomic environment in the last quarter of 2006 has evolved broadly in line with the outlook set out in the October Inflation Report. Our forecasts in the June and October Inflation Reports suggested a widening output gap. Indeed, the GDP growth rate slowed down and the output gap has widened in the second half of the year as expected (Figure 4). Accordingly, we envisage that contribution of the demand conditions to the disinflation process has increased.

Figure 4: Output Gap



Source: CBRT

Global economic growth has become more balanced across regions, with some deceleration in the US and resilient growth elsewhere. Domestic demand in the Euro area has maintained its momentum and therefore continued to provide support for our exports, which was a largely anticipated development in our October Inflation Report.

Recall that, the October forecast assumed that risk premium would stay unchanged, unprocessed food prices would normalize, and oil prices would remain constant. There was no significant change in the risk premium since October. Some “correction” in unprocessed food prices has been witnessed, although not as significant as predicted. On the other hand, oil prices continued to surprise on the favorable side. Accordingly, we have revised our oil price assumption down from 60 to 55 USD per barrel. However, our forecasts still incorporate the estimated impact of accumulated past increases in oil prices on regulated prices such as natural gas and electricity.

The decline in the inflation expectations has continued to tighten the monetary conditions in the last quarter of 2006. Longer-term interest rates such as the interest rates on government securities and consumer loans stayed at higher levels. Although some uncertainties remain over the impact of the policy rates on economic activity, it is reasonable to assume that current financial conditions and monetary policy stance in Turkey are non-accommodative.

Table 4: Consumer Loans and Claims From Credit Cards

(Quarterly Real Percentage Change)

	2005Q2	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4
Consumer Loans	23.4	23.3	14.4	17.2	20.0	1.5	3.3
Housing Loans	61.9	50.6	33.3	29.2	22.8	0.9	2.0
Automobile Loans	11.7	11.4	6.0	1.9	5.1	-6.4	-5.5
Other Loans	11.7	11.3	1.6	11.7	24.3	6.0	8.7
Claims From Credit Cards	8.4	6.3	2.3	2.0	6.8	2.1	4.4

Source: CBRT.

The third quarter GDP figures have revealed a significant slowdown in the private consumption demand. The significant slowdown in credit expansion and the notable decline in the growth rate of monetary indicators continued in the last quarter of 2006. Credit expansion has almost stopped in the second half of the year (Table 4). Automobile sales registered a sharp decline in the third quarter. Although there has been some recovery in the last quarter of 2006, annual growth rate in automobile sales is still significantly negative. Consumer confidence index fell in June and July before it rebounded modestly in the last couple of months.

In sum, recent indicators suggest a considerable slowdown in the *private* consumption, especially in interest rate sensitive items such as car sales and housing. The slowdown in the a*ggregate* demand, however, has been less significant, mainly owing to the robust external demand and the noticeable rise in non-interest public expenditures (Table 5). In other words, the increase in government spending has partly offset the impact of the tight monetary stance in the latter part of 2006. Seasonally adjusted figures for the capacity utilization rate and the industrial production indices suggest that although there is some modest recovery in the last quarter, the growth rate in the economic activity was significantly lower than the post-2001 average.

Table 5: Developments in Consumption Demand

(Annual Percentage Change)

	2004	2005					2006			
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Nine Months
Consumption Expenditures	9,0	4,1	3,9	9,8	14,1	8,1	8,4	11,1	2,3	6,9
Public	0,5	4,4	4,0	3,2	0,0	2,4	8,1	18,0	15,4	14.2
Private	10,1	4,1	3,9	10,4	16,7	8,8	8,4	10,4	1,3	6.2

Source: TURKSTAT.

Outlook

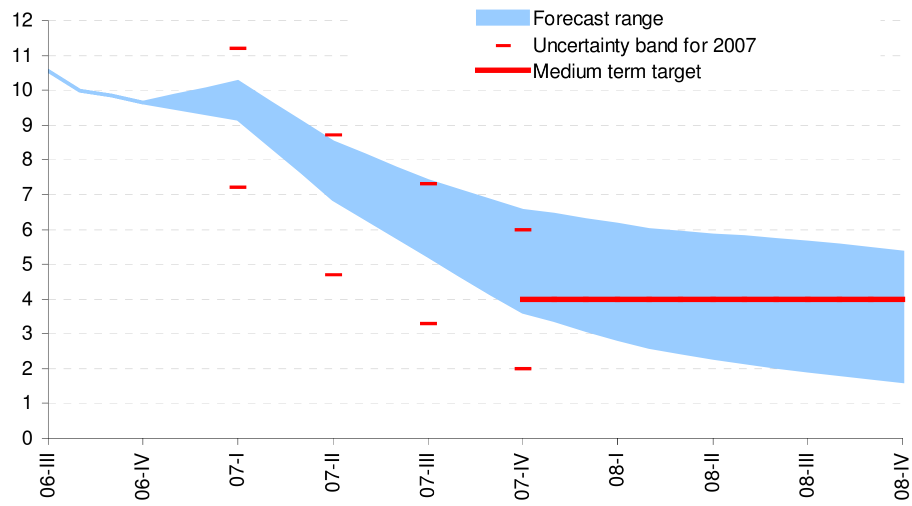
We expect aggregate demand conditions to support the underlying disinflation process in the next couple of quarters. Although the exports are likely to grow faster than the imports in the first half of the year, our projections suggest that the modest growth in the private domestic demand will continue to hold the GDP growth rate at levels below the previous years. We envisage that the non-accommodative monetary conditions and the slowdown in economic activity will limit the second-round effects of the supply shocks witnessed in 2006.

Another factor that could contribute bringing inflation down in 2007 is the high base created by the supply shocks cited above. The normalization of food, energy and other commodity prices together with the disappearance of the base effect of exchange rate pass-through have the potential to drive a sizeable reduction in annual inflation, especially starting from the second quarter of 2007.

Inflation in services prices has been quite persistent, possibly due to the presence of backward-looking pricing behavior and relatively low productivity in the services sector. Also, the recent pension and minimum wage increases together with the civil service wage hikes put an upside pressure on services and overall inflation.

Against this background, bringing inflation back to the target of 4 percent necessitates a tight policy stance. Assuming that the policy rate is unchanged for the next three quarters and gradually eased thereafter, we forecast inflation to be between 3.6 and 6.6 percent (mid-point 5.1) at the end of 2007 and between 1.6 and 5.2 percent (midpoint 3.4) by the end of 2008, with 70 percent probability (Figure 5). We expect the downward trend in inflation to become more pronounced in the second and third quarter of 2007. Our projections suggest that it may take around 5 quarters to converge to target. It should be stressed that both the inflation forecast and the underlying policy path is conditional on the currently available information, and therefore, subject to change as new information arrives.

Figure 5: Inflation Projections*



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

To sum up, since macroeconomic developments have evolved in line with the outlook presented in the October Inflation Report, there has been no significant revision in our medium term forecasts and the underlying policy perspective.

Risks

The main risk factor for the medium term inflation outlook can be listed as higher-than-expected inflation inertia, as currently manifested in the medium term inflation expectations. Given that we plan to bring inflation down from 10 percent to 4 percent in a fairly short period of time, the degree of stickiness in services inflation emerges as a major risk to our forecast, especially if one considers the recent real wage awards. Realization of such a risk could require keeping the tight policy stance longer than envisaged in our baseline forecasts. Accordingly, we will continue to keep a close eye on the services price inflation along with various core inflation measures.

Another risk for the inflation outlook is the uncertainty regarding impact of monetary policy on the aggregate demand. Lags in monetary policy transmission are time variant, and the Turkish economy is no exception. The sizeable slowdown in the third quarter of 2006 was a result of lower confidence due to financial market volatility in May-June period, rather than an outcome of tightened monetary policy. Although the tightening exercised since June 2006 started to be effective on the interest-sensitive private demand recently, the extent and the duration of the slowdown in the overall economic activity remains to be seen. Uncertainties are also related to the behavior of government spending, which could represent an upside risk to the aggregate demand, and therefore inflation in 2007. In this respect, the MPC has been closely monitoring the macroeconomic impact of the developments in the incomes policy as well as the public sector non-interest expenditures.

A third risk factor that may put delay in attaining the medium term targets is the possibility of a sudden change in the global financial market sentiment. Global liquidity is still the major factor in shaping risk appetite and volatility in financial markets. Currently the concerns over high inflation and thus higher interest rates in the United States seem to have diminished. However, a sharper-than-envisaged slowdown in the world economy or disorderly developments owing to global imbalances still remain as possible scenarios that may lead to another wave of portfolio shock in emerging markets. It should be stressed that in June we have designed a flexible tool to cope with such possible sudden changes in the market sentiment. The current liquidity conditions in the domestic money market allow us to engineer a rapid tightening in operational policy rates between the two MPC meetings. We have already announced in our policy statements that the CBT will not hesitate to resort to this kind of tightening, should the market conditions exhibit a sharp but temporary deterioration. In case the deterioration turns out to have lasting effects on the medium term inflation outlook, the MPC will revise the borrowing rates upwards.

It is worth to note that, not all the scenarios regarding the global outlook are unfavorable for our economy. Turkey is a net commodity importer. Although a slowdown in the global economic growth or a further easing in commodity prices could have an immediate adverse impact on the domestic inflation through its impact on the global risk appetite, it will also lead to a positive terms of trade shock and thus to a more favorable outlook in the medium term.

Conclusion

Although the accumulated impact of the various cost-push shocks combined with the continued exchange rate pass-through has kept inflation at high levels, the policy we have conducted since June 2006 has been successful in containing inflation and inflation expectations. Inflation is already down to single digits from its peak of 11.69 percent in July 2006; however, it is still significantly above the medium term target of 4 percent. Given the prevailing uncertainties over the medium term outlook, monetary policy needs to remain tight to ensure the convergence to medium term targets. That is why we will conduct monetary policy with a tightening bias in the period ahead. In other words, monetary policy will stay more attentive to adverse developments than favorable developments regarding inflation outlook. This approach reflects our commitment to achieving the medium term inflation target.

It should be stressed that an appropriate monetary policy is a necessary but not a sufficient condition for achieving long run price stability. Attaining high primary surpluses have been central for the disinflation process in the past years. Maintaining and advancing the gains achieved thus far requires the continuation of the European Union accession process, and the implementation of structural reforms that would ensure the sustainability of fiscal discipline in the long run.

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