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SUMMARY OF THE MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 25 May 2006

1. The Monetary Policy Committee (the Committee) takes its decisions in order to ensure the consistency of inflation with the medium-term targets. Therefore, the important point for monetary policy is the information content of the announced data pertaining to the medium-term outlook of inflation. Seasonal movements or one-off shocks on supply and costs may cause unexpected jumps in monthly inflation. Inflation figures may be higher or lower than the expected level, especially in periods where prices of some sub-items such as food and clothing might display high volatility due to seasonal factors. The information content of the figures for a single month may be limited regarding the inflation outlook in the upcoming period. Therefore, the monthly data should be handled cautiously. Accordingly, during the inflation targeting period, the Central Bank set its main communication tool as the Inflation Report, published quarterly, rather than monthly reports. In this framework, the quantitative forecasts regarding the medium-term course of inflation are revised once a quarter. Current data are carefully monitored and interpreted along with the outlook presented in the Inflation Report.

Evaluation of Price Developments

2. The price developments in April can be evaluated from two different aspects; monthly and annual increases:

    a. In April, consumer prices displayed a high increase of 1.34 percent on a monthly basis. Regarding *monthly* price increases, one of the main factors standing in the forefront is the unfavorable impact of price movements on the food sub-group. This development stemmed from unprocessed food products. Meanwhile, it is observed that the price increases in processed food products are at low levels and pursue a stable course. This observation indicates that the high increases in the food group can be offset by the declines in summer. Besides, gold prices, which displayed a rapid rise in April, have been one of the factors that led to high monthly inflation figures.

    b. While interpreting *annual* inflation figures, it should be kept in mind that the prices of items, such as alcoholic beverages-tobacco, energy, gold and unprocessed food, which are beyond the control of the Central Bank, displayed high-rated increases in the previous twelve-month period. If the growth rate of the index excluding the mentioned products is analyzed, the main trend of inflation is not inconsistent with the medium-term targets.

c. In summary, although the inflation figures pertaining to April were above expectations, in light of the evaluations above, they do not include adequate information that would make us revise our medium-term perception.

3. It is predicted that in May, the high levels of oil and gold prices along with the recent developments in exchange rates will lead to a rise of 0.4 percentage points in the monthly inflation figures solely via gold and petroleum products. In other words, exogenous factors will not have a favorable impact on May inflation. Furthermore, it is difficult to make predictions about the prices of unprocessed food and clothing due to likely seasonal volatilities in May, it will not be appropriate in this month, as in April, to make a specific comment by only considering the monthly inflation figures without taking sub-items into account.

4. The evaluations above are based on the latest price developments. The analysis of expectations, cost factors and pricing behaviors are of great importance in the formation of the inflation outlook and the future course of monetary policy.

Factors Affecting Inflation

5. The latest developments in supply and demand displayed a course consistent with the forecasts presented in the Inflation Report. The investment tendency remained strong and the revival in demand continued without any acceleration tendency. Moreover, it was seen that the slow-down observed in production at the start of the year was temporary. However, the Committee re-evaluated the outlook in light of recent developments in financial markets.

6. In the previous Inflation Report, it was projected that the downward trend in inflation would continue under the base scenario where oil prices followed a horizontal course and no unfavorable development would occur in the risk premium. Moreover, it was clearly stated that the difficulty in the predictability of the global risk appetite and international liquidity conditions was still a risk factor. Actually, as part of the funds previously directed to emerging markets moved to developed countries that is perceived as more secure, this risk has been materialized. This circumstance has had a negative impact on emerging markets including Turkey and has led to fluctuations in financial markets.

7. These developments have affected short-term inflation expectations adversely. However, the fact that the rise in medium-term inflation expectations has remained lower compared to the rise in short-term inflation expectations shows

that the confidence in the disinflation process would continue. Nevertheless, the gap between expected and targeted inflation rates, which tends to expand, is a development that requires a close monitoring for the sake of monetary policy.

8. At this point, in light of recent developments, the future trend of inflation and the corresponding future monetary policy is of utmost importance.

9. First, we should consider the short-term outlook. Due to the recent fluctuations in financial markets, the short-term outlook presented in the last Inflation Report has changed. The fluctuations in financial markets would have direct effects on production, demand and costs in the short run. A downward trend would not come as a surprise in the real sector and consumer confidence indices, which have started to improve in April. The rises in prices of capital goods and interest rates with the fluctuations in financial markets will affect the investment tendency in the short run. Increased interest rates as well as decreased relative price advantages in consumer durables will shrink consumption demand and imports of consumption goods will slow down in the upcoming period. However, due to structural reasons, it is estimated that the slowdown in imports of intermediary goods will be limited. All these factors reduce the probability of a demand-push pressure on inflation in the short term.

10. Despite the slowdown in demand, inflation might be adversely affected in the short run. The projections presented in last month's Inflation Report were based on the assumption that no sharp turn would emerge in international liquidity conditions and that the New Turkish lira would continue to contribute to the disinflation process by retaining its strong position. However, based on the recent developments, these assumptions have become void, at least for the short run. Prices of sub-groups under the Consumer Price Index such as medicine, natural gas, oil, diesel oil, LPG, package tours abroad, gold and imported coal are *directly* affected by changes in exchange rates very quickly. In other words, it is inevitable that the fluctuations in exchange rates will influence inflation via direct cost channel in the short run.

11. However, it should be highlighted here that thanks to the reduced inflation rate, the floating exchange rate regime, increased competition, and economic policies focused on stability, pricing behaviors have been changing in the last couple of years. Within this context, it is projected that the indirect effects of exchange rate developments on inflation would be phased over in time and the total magnitude of the effects would depend on whether the movements in exchange rates are temporary or permanent.

12. Accordingly, the direction and magnitude of the policy response of the Central Bank may vary depending on whether the fluctuations are temporary or permanent. The studies that have been carried out at the Central Bank indicate that the indirect effects of exchange rates on inflation start to accelerate the

third month onwards. Departing from this observation, it can be asserted that most of the indirect effects will be contained if the fluctuations in the markets are of a temporary nature. In this case, inflation will soon resume its declining trend and there will be no need to tighten policy rates. In case the depreciation in the New Turkish lira gains a long-lasting nature and the rise in the risk premium continues, the unfavorable effects on inflation are more likely to spread to the medium-term and, in such a case, policy rates will need to be tightened in order to meet the medium-term inflation target.

Inflation Trend in the Medium-Term

13. One point should be emphasized with regard to inflation trends in the medium-term. Despite the deterioration in the risk appetite and international liquidity conditions, many other factors that supported the downward trend in inflation in recent years are very likely to continue to contribute to this trend in the upcoming period. It is anticipated that unit labor costs will remain limited in the forthcoming period, due to the high labor force participation rate resulting from demographic factors; tougher competition, driving firms to maintain increases in productivity; and structural transformation in the agricultural sector. Clearly, this anticipation is based on the assumption that the income policy will also continue to be pursued in line with the inflation target. In this respect, it is expected that the contribution of supply and demand conditions to the disinflation process will continue.

14. Another factor that supported the downward trend in inflation in recent years is the fact that low labor costs in countries such as China and India restrained the increases in prices of tradable goods through international competition. Considering the rapid rise of the Turkish economy’s level of integration with the world, it is anticipated that the said mechanism will continue to contribute to the disinflation process in the upcoming period.

15. The steps already taken and those planned towards structural adjustments in areas of fiscal discipline, taxes, social security and the European Union accession process will provide support to the fight against inflation via expectations. As long as progress is made in structural adjustments that will ensure fiscal discipline and economic stability, the impacts of exogenous shocks will remain limited.

16. Although the support of all these factors to the disinflation process is expected to continue in the medium term, none of them ensure that inflation will be consistent with medium-term targets. The commitments of the Central Bank stand as the most solid assurance in this regard. It should be emphasized once more that a monetary authority with instrumental independence, whose main objective is to establish price stability, will certainly respond if there are strong indications that inflation could considerably deviate from targets in the medium term.

17. End-year inflation targets for 2006, 2007 and 2008 have been set at five percent, four percent and four percent, respectively. In the light of available information, though inflation is very likely to be above the target at end-2006, the Central Bank will give the appropriate response in order to maintain consistency between the 2007 inflation and the target in the medium-term perspective.

18. Price stability is a *sine qua non* for macroeconomic stability and sustainable growth. Significant steps have been taken towards this end in recent years. The Central Bank will continue to play its part in building on these achievements. In order to prevent persistent exogenous shocks from threatening price stability, a prudent monetary policy as well as fiscal discipline should be maintained. It should be kept in mind that the main determinant of sustainable non-inflationary growth is the confidence in lasting macroeconomic stability. In this context, ongoing determination in the implementation of structural regulations that would further increase the quality of fiscal discipline and continuance of reforms, which would improve the competition and investment environment and support productivity increases in the long term, are of critical importance. Besides, avoiding any implementation that would damage the expectations about economic fundamentals is crucial for sustaining the resilience of the economy to exogenous shocks.

19. In consideration of the available information, it should be noted that, although it is still early to change the medium-term outlook, policy rates are less likely to decrease in the short term. In the upcoming period, policy rate decisions will be conditional on international liquidity conditions, changes in the risk premium and other developments. The direction and magnitude of policy response can vary depending on whether the effects of fluctuations are temporary or permanent.

20. It should be emphasized that any new data and information associated with the inflation outlook will lead the Monetary Policy Committee to potentially revise its stance regarding the future.