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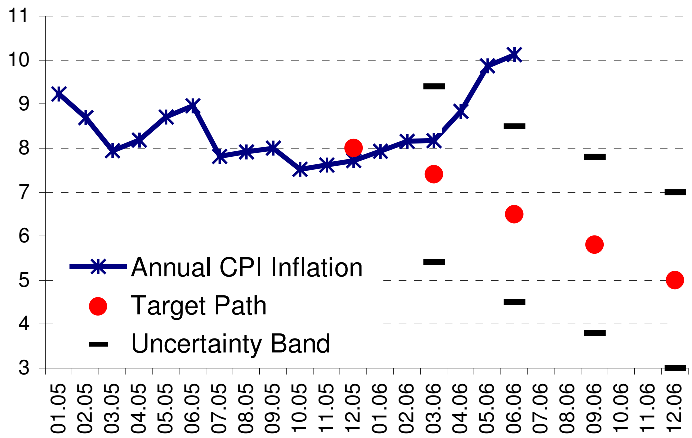
Central Bank of Turkey (CBT) adopted a formal inflation-targeting framework at the beginning of 2006. The general framework of monetary policy was explained in the policy statement dated December 5th 2005. Accordingly, the end-year annual inflation target for 2006 was set as 5 percent. The CBT has also disclosed a quarterly path of inflation for 2006 consistent with the end-year target with an uncertainty band of 2 percentage points on both sides (Table 1).

Table 1: Inflation Path Consistent with the End-Year Target and the Uncertainty Band

	March 2006	June 2006	September 2006	December 2006
Uncertainty Band (upper limit)	9.4	8.5	7.8	7
Path Consistent with the Target	**7.4**	**6.5**	**5.8**	**5**
Uncertainty Band (lower limit)	5.4	4.5	3.8	3

Figure 1 shows the target path and the actual inflation outcomes. The target for 12-month CPI inflation in June 2006 was set at 6.5 percent, with an upper limit of 8.5 percent. The actual outcome for 12-month inflation in June 2006 is 10.12 percent. As stipulated in Article 42 of the Central Bank law, the CBT will 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. This open letter serves this purpose. As mentioned in our policy statement titled "General Framework of Inflation Targeting and Monetary and Exchange Rate Policy for 2006" published on December 5, 2005, the public announcement to be made in such a case will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual CPI Inflation and Target Path



Source: CBT, TURKSTAT

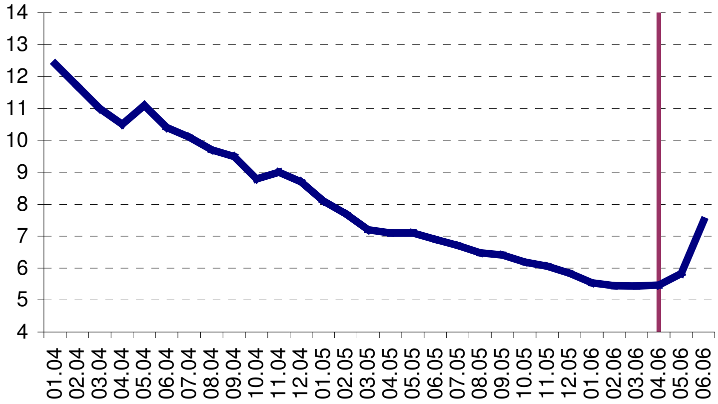
Under the inflation targeting regime, monetary policy is based on a medium term perspective in which the main goal is to ensure the consistency of medium term inflation forecasts-and expectations- with the multi year targets. The main communication device is the quarterly Inflation Report. We have published our first inflation report in January 2006 along with quantitative inflation forecasts. Following the most recent literature on inflation targeting, we based our forecasts on an endogenous policy path in which the CBT reacts to the deviations of projected inflation from the targeted path. Consistent with this approach, we have made it explicit that underlying our January forecast was a policy rate path that would be constant in the first couple of months of 2006 and gradually ease thereafter. Under this scenario, our end-year 2006 inflation forecasts pointed to a range between 4.7 percent and 6.3 percent, which was inside the uncertainty band of 3-7 percent with a safe margin.

The forecasts in the Inflation Report suggested that annual inflation would start to decline gradually in the second quarter of 2006 after exhibiting a slight increase in the first quarter due to some base effect. In the Inflation Report of January 2006, the CBT had identified two major risks to the forecast: First, it was argued that the forecasts were based on a constant oil price path and thus further increases in the oil prices might lead to higher inflation than projected. Second, we mentioned the possibility of a reversal in global liquidity conditions and a decline in global risk appetite, both of which had been favorable for emerging markets in the last couple of years.

Reasons for Breaching the Target

The main reasons for inflation exceeding the upper limit of the uncertainty band in June 2006 can be attributed to a combination of several supply shocks. The first four months were dominated by rising oil prices, increases in the tobacco product prices, high unprocessed food price inflation and the continued increases in the gold prices. It is important to note that, despite these adverse supply factors, inflation expectations were well behaved in the first 4 months of 2006 (Figure 2).

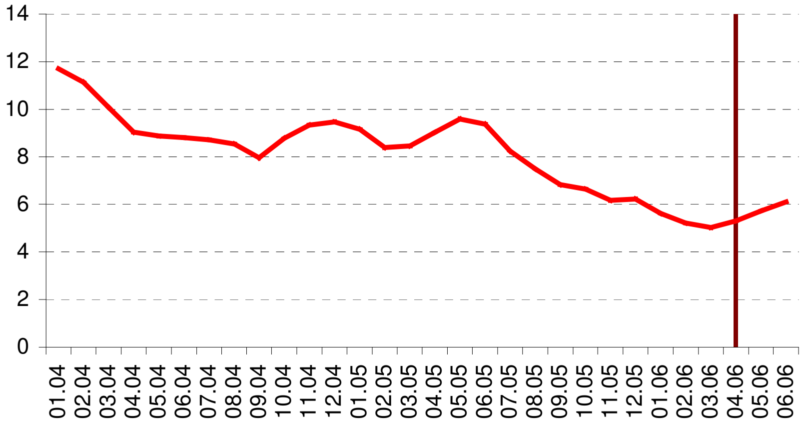
Figure 2: Inflation Expectations for the Next 12 Months



Source: CBT

12-month ahead inflation expectation in April was around 5.4 percent, close to our medium term targets. Annual change in the CPI excluding the most volatile items such as unprocessed food, tobacco-alcohol, energy and gold was on a declining trend (Figure 3); with an annual change of 5 percent by the end of March, suggesting that the rise in headline inflation was likely to be temporary and that underlying inflation trend was much lower than the actual headline inflation. Moreover, the sustained decrease in the risk premium in the first quarter supported the policy action of further monetary easing. Although the domestic demand indicators were pointing to a robust recovery, there were no signs of overheating in the overall economic activity. Various indicators, such as capacity utilization rates, working hours in the manufacturing industry and the output gap estimates pointed the absence of capacity pressures in the economy. All these observations suggest that supply factors played a dominant role in rising inflation.

Figure 3: CPI Excluding Energy, Unprocessed Food, Alcoholic Beverages, Tobacco Products and Gold (Annual percent Change)



Source: CBT

This outlook has allowed the Monetary Policy Committee (MPC) to stick to the policy path underlying the January forecast and the policy rates were cut by 0.25 percentage points in the April meeting. April inflation figures, which came out a couple of days after the policy rate cut, turned out to be much higher than market expectations. However, as mentioned above, a closer look at the April figures revealed that inflation was mostly due to supply-side factors such as unprocessed food, gold and energy prices.

Nonetheless, the overall market sentiment began to shift in May, as global liquidity conditions started changing in favor of developed countries. Higher global risk aversion has triggered capital outflows in many emerging markets such as Turkey, Hungary and South Africa. In other words, one of the major risk factors we have mentioned in our Inflation Report was realized. Turkey has witnessed a sudden deterioration in the credit risk premium (measured by the EMBI spread) by around 150 basis points during May and June and the New Turkish Lira depreciated more than 20 percent against the US$ in the meantime.

The direct impact of the exchange rate pass-through was visible through items such as gold, petroleum products and electrical appliances etc. in May. Moreover, the unfavorable course of unprocessed food and international gold prices continued in May. As a consequence annual inflation rose to 9.86 percent. Our computations point to a direct pass-through impact of around 0.6 percentage points in May and another 0.9 points in June. In other words, had the exchange rate not moved in the last two months, annual inflation in June would have been around 8.6 percent—not 10.12 percent. Therefore, the outer band would have been most likely breached with a small margin even in the absence of the recent exchange rate movements.

How did the Monetary Policy Respond?

Coupled with the aforementioned supply shocks, depreciation of the domestic currency has led to deterioration in inflation expectations (Figure 2). 12-month ahead inflation expectations increased by almost 2 percentage points in two months. What is more, the 24-month ahead expectations worsened by about 1 percentage point. These developments have indicated that the impact of depreciation on prices might go way beyond a relative price adjustment, calling an immediate policy response. CBT reacted decisively by holding an extraordinary MPC meeting on the 7th of June in which the policy rates were hiked by 175 basis points. The decision was well received and helped the markets to calm down.

In the ordinary meeting of the MPC dated June 20, the Committee assessed that the information flow between 7th and 20th of June did not justify a change in the policy stance and decided to keep the policy rates on hold. Nevertheless, markets turned more unstable and inflation expectations deteriorated sharply in the following days, calling for immediate action. As a response, the MPC held another extraordinary meeting on the 25th of June 2006 to assess the developments and to discuss the measures to be taken. Members of the Committee have reached a consensus on the view that; although the extent of the market instability did not reflect the true economic fundamentals, it had the potential to further worsen the expectations and thus threaten the medium term inflation targets. The response of the MPC was a rate hike of 225 basis points, reaching a total of 400 basis points tightening in June.

The CBT not only tightened by increasing the policy rate but also by withdrawing the excess YTL liquidity in the financial markets through a combination of one and two week deposit purchase auctions and FX sales in order to reduce the excess New Turkish Lira liquidity in the overnight money market, while raising the lending rate up by a total of 600 basis points. By doing so, the CBT has also aimed at easing the excess volatility in the financial markets originating from factors that are independent from economic fundamentals. Hence, the CBT has explicitly demonstrated its commitment to the medium term inflation targets.

Markets reacted positively to this package, with lower bond yields possibly reflecting a reduction in inflation uncertainty. Table 2 shows the CBT overnight borrowing rates set at each of the 2006 meetings of the MPC.

Table 2: MPC Decisions in 2006

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

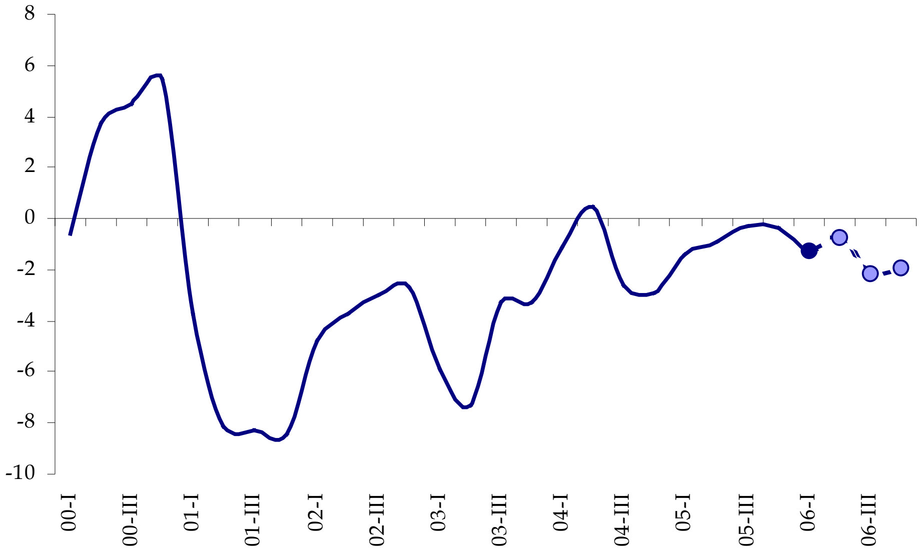
(1) extraordinary

Medium Term Inflation Outlook

The CBT conducts monetary policy based on the evaluation of the future trend of inflation. In assessing future inflation, the CBT uses the best available information, both quantitative, using structural models, simulations and other statistical measures, and qualitative which demands a more subjective analysis. Taking the monetary policy measures in June into account and assuming that the monetary policy will preserve its prudent stance, this section of the letter evaluates the medium term outlook of inflation.

While the recent volatility in the financial markets is expected to slow down the domestic demand growth, the depreciation of the domestic currency is likely to have a favorable impact on net exports. However, it is expected that the slowdown in domestic demand will surpass the rise in net foreign demand, leading to an overall decline in the aggregate demand for home goods. In other words, the net effect of the recent volatility on the aggregate demand is expected to support the disinflation in the second half of the year 2006. In light of these assessments, the output gap is expected to widen for the remainder of the year (Figure 4). The economic activity is projected to pick up gradually in the medium term.

Figure 4: Output Gap

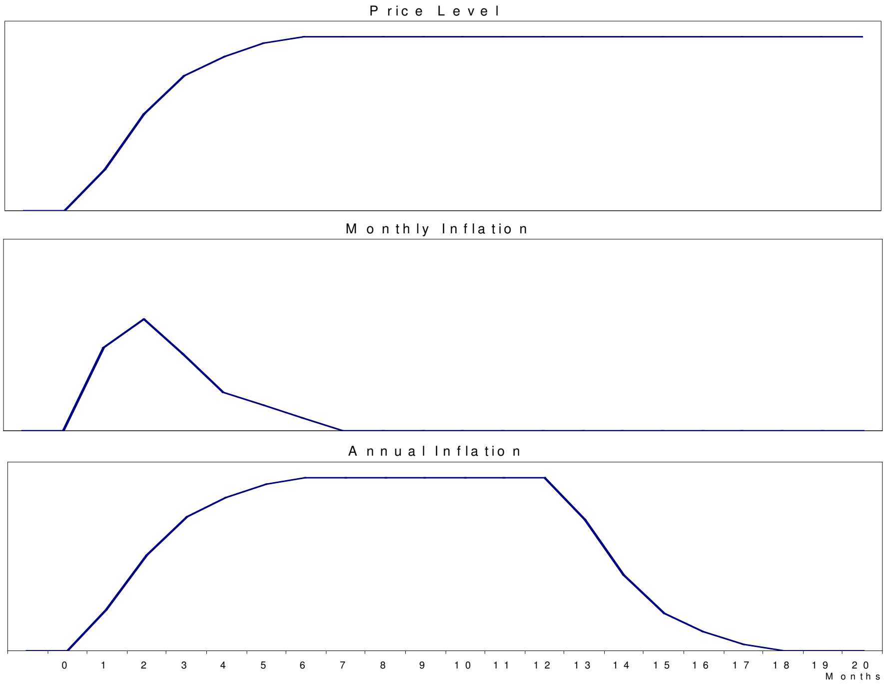


Forecasting the course of inflation in the near term requires an assessment of the pass-through impact of recent movements in exchange rates. Although empirical evidence shows that exchange rate pass-through has been significantly reduced after the adoption of floating exchange rates, our studies suggest that the impact on the price of tradable goods may still be sizeable. Using the techniques developed by our staff, our computations point roughly to a cumulative of 3.5 percentage points of pass-through impact on headline CPI inflation throughout 2006. It is noteworthy to emphasize that, we contemplate the impact of exchange rate on inflation to take the form of a change in relative prices between tradable and non-tradable goods rather than price readjustments. In such a case, overall impact on inflation will be temporary so long as the medium to long-term expectations are under control.

At this point, it will be helpful, using a hypothetical case, to illustrate the typical behavior of the price level, monthly inflation and the annual inflation upon an exchange rate shock in the absence of second round effects. Assuming that exchange rate exhibits a one-time shift at period zero, Figure 5 depicts the price level and inflation paths induced by the direct pass-through effect. Note that even if there are no second round effects, the change in headline index induced by the relative price adjustments (first order effects) may take several months. Our example assumes a 6 months adjustment period (possibly due to staggered price setting in the economy). This lagged pass-through dynamics is also consistent with the Turkish case in which most of the direct impact is completed in 6 months.[1]

[1] Although empirical evidence shows that the pass-through impact may last more than 6 months, one should note that this finding involves *both* the first round and second round effects throughout the sample period.

Figure 5: Behavior of price level and inflation after a one-time jump in the exchange rate

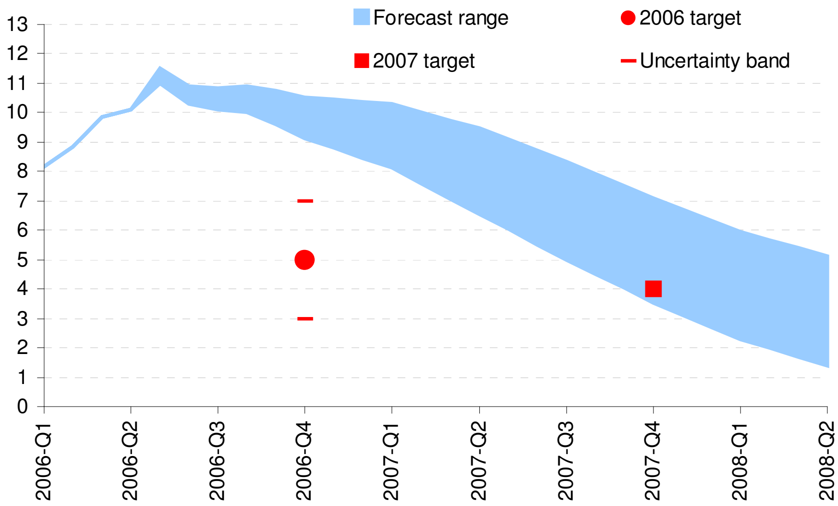


Two main results can be deduced from this exercise: (i) As long as the second round effects are negligible, the impact of a one time jump in exchange rates on inflation is bound to be temporary. (ii) Provided that the impact on the price level dies out in T months (6 months in our example), monthly inflation is affected for T months while annual inflation stays above the steady state for T+12 months (18 months in our case); therefore, *ceteris paribus*, it will take 18 months for the annual inflation rate to return to the target. This simple observation explains why it may take more than a year to bring *annual* inflation down after a significant exchange rate shock.

Our recent policy responses should be interpreted as an intention to realign inflation expectations, to avoid the propagation of supply shocks, and to inhibit a generalized increase in prices. Accordingly, we expect the monetary tightening to contain the second-round impact of the recent exchange rate movements on 2007 inflation, partly due to the slowdown in the overall economic activity. Although the implied inflationary inertia may still add another 1 percentage point to the headline CPI inflation in 2007, our aim is to keep this effect at a minimum level.

Against this background, our latest forecast constructed using a constant policy rate suggest that inflation will be between 9.1 and 10.5 percent at the end of 2006 with 70 percent probability (Figure 6). Besides the slowdown in domestic demand, we expect that unprocessed food prices will normalize (which already showed signs of normalization in June), the one-off increases in tobacco prices will disappear and the impact of exchange rate pass-through will gradually fade out in the medium term. We project the annual inflation to come down after the first quarter of 2007, the downward trend becoming more significant in the second half of the year. Inflation is expected to converge to the target around one and a half to two years time. The forecast indicate a range between 3.5 and 7 percent for end-2007. Given that this forecast is created under the constant rates assumption, adherence to the 4 percent target may require some further policy tightening.

Figure 6: Inflation Projections for 2006 and 2007 (Preliminary)*



*** Current forecasts are based on information as of July 10th, and thus, may differ from the forecasts in the July Inflation Report, which will be published on the 28th of July. The shaded region indicates the 70 percent confidence interval for the forecast.**

Note that, that the chance of inflation staying within the shaded region is 70 percent, i.e. there may be breaches around the baseline projections, especially in the presence of large shocks. One such risk is the possibility of a sustained rise in oil prices. The CBT will accommodate the first order effect of oil shocks, which mainly works through energy and transportation prices. However, the CBT will monitor the pricing behavior closely and will not hesitate to react to any deterioration in medium term inflation expectations.

Latest developments have signaled that, a shift in investor confidence originating from changes in expectations or swings in the global risk appetite are among major risk factors for the medium term forecasts. Should such a risk realize and the exchange rate exhibit significant fluctuations, the CBT will act in line with its medium-term approach: It will not react to changes in relative prices, but stand ready to respond to any deterioration in medium term inflation expectations. Also, in such a case the excess liquidity in the market will be managed carefully to dampen the potential volatility in the financial markets.

Conclusion

In sum, breaching the upper bound of the uncertainty band of inflation target in June 2006 can be attributed to two major developments. First, one of the risk factors we have set out in our inflation reports, namely the change in the global liquidity conditions, has been realized. Second, there have been unexpected increases in the volatile prices such as unprocessed food, gold and energy 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 suggests that the role of the supply factors in breaching the target, by and large, was dominant. The CBT has already responded vigorously to bring inflation back to the targets. Our recent forecasts suggest that medium term targets are attainable under a cautious monetary policy stance. However, it should be carefully noted that, these assessments are made within a context where the fiscal discipline is not relaxed, the income policy is in line with the inflation targets and that expectations are managed properly.

The current macroeconomic framework in Turkey is built on three fundamental pillars: inflation targeting, floating exchange rate regime and prudent fiscal policy. This framework has proven to be effective in dealing with the sequence of shocks to the Turkish economy, keeping inflation - and inflation expectations - under control. The Central Bank of Turkey remains attentive to developments in the economy in both domestic and external fronts. Our end year 2007 and 2008 targets remain as 4 percent. As in the recent past, the CBT will react promptly to events that would endanger the achievement of the policy targets.

CENTRAL BANK OF THE REPUBLIC OF TURKEY

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