

SUMMARY OF MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 20 July 2006

Inflation Developments

1. The Central Bank of the Republic of Turkey (Central Bank) has started to publish a technical note focusing on inflation developments within two days of the announcement of price indices with the aim of contributing to the better understanding of monthly inflation data. In this framework, as was stated in the press release dated July 4, 2006, the decline in prices of unprocessed food along with the rise in prices of consumer durables and energy prices due to developments observed in exchange rates became the determining factors for inflation in June. Thus, the impact of exchange rates on annual inflation in the last two months reached 1.5 percentage points.
2. It is estimated that the effect of exchange rates on prices will continue to be felt strongly in July and eventually start to diminish as of August. However, as it will take more than a year to mop up the effects of supply-oriented developments observed in the last few months on annual inflation, annual inflation will continue to be high in the short-term. The measures taken by the Central Bank in June will ease pressures on inflation in the upcoming period.
3. Annual inflation of the CPI excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold, which is calculated in order to measure the general inflation trend, increased compared to the previous month and reached 6.1 percent, while the monthly rise became 0.54 percentage points, when seasonally adjusted. It is estimated that this rate will continue to increase in July also.
4. Effects of the recent movements of exchange rates on inflation can be handled in two categories as primary and secondary effects. Primary effects cover mostly price adjustments in prices of goods with a high imported component. These effects, which are observed as the relative price discrepancy between tradable goods and non-tradable goods, can lead to a temporary rise in inflation. However, such effects do not change the medium-term inflation trend, as they do not disrupt the general pricing behavior. Therefore, central banks that act on medium term perspective do not give policy responses to these primary effects.
5. The secondary effects emerge when the rising tendency of prices is not limited to goods with imported components, but is spread to the entire economy. Such an effect, which might lead to an uninterrupted rise in the general price level, may mean that the rise in inflation is permanent and in such a case reducing inflation again would be too costly. Therefore, while evaluating the effects of exchange rates and oil prices on inflation, central banks attach great importance to the secondary effects.

6. The secondary effects arise mainly through expectations. Therefore, the recent developments in inflation expectations have become more significant. The supply-oriented shocks that had significant pressure on inflation along with the rapid depreciation of the national currency have disrupted inflation expectations. In other words, the risk of disrupting pricing behavior of the entire economy has emerged. No significant improvement was observed in medium-term expectations as of the first half of July. Even if it is expected that the recent decisions of the Committee will contribute to improving expectations and curbing secondary effects, there is still the need to adopt a cautious stance.

Outlook and Factors Affecting Inflation

7. By increasing the tendency to avoid risks, the recent fluctuations in financial markets are naturally reducing banks' appetites to provide credits. Moreover, the rise in short-term interest rates that also boosted the costs of funding stands as a factor that could tighten the supply of credit. The Central Bank sterilized the excess liquidity in the market via weekly and bi-weekly New Turkish lira (YTL) deposit purchase auctions as well as via foreign exchange sales auctions, which led to a decrease in the amount of funds banks can convert to credits. This development stands as another factor that might tighten the supply of credit.
8. The rise in credit interest rates in the recent period leads to a decline in the amount of credit demanded. The slowdown in credits, which is expected to be observed in line with the rise in interest rates, emerges with a time lag due to the rigidities in financial contracts. Nevertheless, considering the recent credit developments, it can be said that the rate of increase in consumer credits tends to slow down. In light of currently available information, the slowdown in the rate of increase in credits is expected to become more significant in the upcoming period.
9. Recent developments in financial markets have once again underlined the significance of proper risk management by banks, households and firms under the floating exchange rate regime. In the forthcoming period, the Central Bank will continue to closely monitor banking and credit developments in terms of both financial stability and price stability.
10. Along with the slowdown in credits, the upcoming three-month tendency of domestic market orders and sales indicators from the Business Tendency Survey (BTS) also showed declines in May. Supporting these indicators, domestic sales of automobiles rapidly decreased in June compared to the previous month. Besides, the Consumer Confidence Index also registered a decline.
11. Meanwhile, it is anticipated that net foreign demand will follow a strong course and especially the activity in the production of the export-oriented private manufacturing industry will continue strong due to continued global growth and the depreciation of the YTL. The fact that the Real Sector Confidence Index has not registered a significant decline by June and the capacity utilization rates especially in exports-oriented sectors remained at high levels during the same period also supports this anticipation.

12. As a result, although the Committee projects that domestic demand will lose pace in the second half of the year due to the fluctuations observed in financial markets in May and June and the monetary policy decisions taken, it also expects the strong course of net foreign demand to restrain the slowdown in the economic activity. Nonetheless, taking the economic activity as a whole in view of sectors sensitive to domestic demand such as the services sector, it is anticipated that the decrease in domestic demand will be more determined than the increase in net foreign demand, and thus the contribution of demand conditions to the disinflation process will continue in an accelerated manner in the second half of the year.
13. The fact that no significant decline was observed in investment tendency in the recent period is seen as a favorable development in terms of the continuation of productivity increases. This outlook is anticipated to help keep the secondary effects of exchange rate movements limited. However, there is still a need to remain cautious regarding inflation given that the oil and other commodity prices are still increasing and the expectations are not yet in line with the medium-term targets.
14. Being focused on the 2007 year-end inflation target and taking all these factors into account, the Committee decided to move toward a measured tightening of monetary policy and raised policy rates by 0.25 basis points. In light of the existing risks, the Committee considers that the cautious stance is very likely to continue for some time. Under this cautious stance, the downward trend in inflation is expected to be significant in the second quarter of 2007.
15. There is no doubt that the control of the secondary effects mentioned above will depend mainly on the continuation of fiscal discipline and structural reforms. In particular, in order to attain medium-term targets it is of critical importance that medium-term inflation targets are taken into account in the incomes policy and that the need for unprogrammed public price and tax adjustments is precluded by respecting the limits of budgetary expenditures.

Risks

16. The probability of crude oil prices climbing further continues to be an important risk factor for inflation. As before, the Central Bank will not respond to the primary effects of increases in oil prices. However, it is also true that, along with the deterioration of expectations recently, it became necessary to be more cautious about the secondary effects of oil prices. Should the developments in oil prices affect medium-term inflation expectations adversely or start to disrupt pricing behavior, necessary policy measures will be taken.
17. The main development that marked the economic conjuncture in the recent period is the fluctuations in financial markets, which emerged due to the change in international liquidity conditions. Central banks of developed countries may continue the tightening process because of the concerns about inflation and the extent of further tightening is not clear at this point. This outlook has increased the uncertainties in the global liquidity conditions. The rapid changes in global risk appetite and the possible fluctuations in the global

liquidity continue to be one of the major risk factors for inflation. In case such a risk occurs, the Central Bank will act with a medium-term perspective: It will not respond to the temporary increase in inflation induced by the changes in relative prices, however it will closely monitor medium-term inflation expectations, as it did recently.

- 18.** Along with the decline in inflation in recent years, inflation targets have increasingly become a benchmark variable for pricing decisions. However, the deterioration of medium-term expectations after recent developments, presents the risk of referring to a variable other than the inflation target, such as past inflation, in pricing decisions. In case such a risk occurs, the Central Bank will not hesitate to give the necessary response and will continue its cautious stance until the medium-term inflation expectations of economic agents converge to targets. In this context, the developments that might especially affect expectations, such as international liquidity conditions, the course of domestic demand, pricing behavior and the public sector income policy will be monitored closely in the forthcoming period.
- 19.** Under current conditions, it is of great importance for both price stability and macroeconomic stability that any implementation that would damage risk perceptions and expectations is avoided. Any step towards limiting the risk perception would reduce the cost of attaining and continuing stability. It should be borne in mind that the main determinant of the continuation of non-inflationary growth is the confidence in the permanence of macroeconomic stability. The continuation of a determined attitude towards structural reforms that would increase the quality of fiscal discipline and the uninterrupted implementation of reforms that would enhance the competition and investment environment, and thus underpin increases in productivity in the long term, are of critical importance. In this context, continuation of the European Union accession process and uninterrupted implementation of structural reforms in the economic reform program are crucial. The continuation of the determined steps taken in recent years in this context will help the economy to overcome the changes in the international conjuncture with minimum cost.