

## SUMMARY OF MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Dates: 20 June and 25 June 2006

### *Inflation Developments and Short-Term Forecasts*

1. The rise in inflation in the first five months of the year mainly stemmed from supply-oriented factors. Cumulative increase in the prices of unprocessed food group, which remained almost the same in the first five months of 2005, increased by 11.4 percent in the same period of 2006. Besides, the pass-through effect of exchange rate movements on May inflation was approximately 0.65 percentage points. Excluding the said effects, it is observed that the rate of inflation in the first five months of the year is close to that of the same period in 2005. This observation shows that there were no significant changes in the main trend of inflation in the first five months.
2. Prices of unprocessed food will very likely make a positive contribution to inflation in June and July. Nevertheless, it is anticipated that the *direct* effects of recent volatilities in the exchange rates on consumer prices will persist in June and July and annual inflation will increase during the said period. Meanwhile, annual inflation is expected to decline in August due to the removal of the effect resulting from the high-rated increase in prices of the tobacco and alcoholic beverages group in the same month of 2005.
3. With respect to the assessment of price dynamics in the following months, it would be helpful to evaluate supply, demand and cost developments from *forward-looking perspective*.

### *Factors Affecting Inflation*

4. In recent months, the revival in production and demand continued without further acceleration, and investment expenditures maintained their strong course. However, the macroeconomic outlook needs to be reviewed in the light of recent fluctuations in the financial markets that started in May.
5. Fluctuations in the financial markets, before all else, affected costs of imported inputs. Even if the ongoing increases in partial labor productivity in the manufacturing industry in the first quarter of 2006 ensured the continuance of the downward trend in unit labor costs, the said trend will not be adequate to compensate the high-rated increase in costs of imported inputs. As a matter of fact, the upcoming three-month tendency of the average unit cost indicator of the Business Tendency Survey (BTS) displayed a rapid increase in May.
6. Fluctuations in the financial markets also change demand conditions. The realizations in consumption and investment expenditures point to a strong course in domestic demand in the second quarter of the year. However, rising interest rates, the perception of uncertainty resulting from ongoing fluctuations and the relative price increase in imported goods will unfavorably affect domestic demand in the following period. With rising interest rates and

shortening maturities, the rate of increase in credits has already declined. Expectations in the Consumption Tendency Survey indicate a slowdown in demand. Actually, the upcoming three-month tendency of the BTS domestic market orders and sales indicators showed sharp declines in May.

7. These developments are expected to lead to contractionary impacts on the foreign trade balance and thus, on the current account deficit during the rest of the year. It is anticipated that export performance, especially in labor-intensive sectors, will be positively affected due to the decline in foreign currency-denominated unit wages arising from the depreciation of the New Turkish lira. Meanwhile, it is expected that imports, which has recorded high increases recently, will slow down starting from July. Even though no decreases are expected in imports of intermediary goods due to high levels of energy prices, imports of capital and consumption goods, which have recorded high growth since the second half of 2005, are expected to decrease substantially on an annual basis in the second half of 2006.
8. It is projected that despite of the increase in net foreign demand, the slowdown in domestic demand will be dominant in the short run and the net effect of recent fluctuations on the total demand will be of a contractionary nature. In this framework, the downward pressure on inflation exerted by demand conditions is expected to increase in the second half of the year.
9. Although the investment tendency is estimated to lose pace in the second half of the year, the strong investment realizations of the last three years is predicted to continue to support productivity increases in the medium-term. Moreover, the expanding tendency in labor supply in urban areas stemming from the structural transformation in demographic factors and the agricultural sector will continue to suppress labor costs. In conclusion, it is anticipated that unit labor costs will continue to contribute to the disinflation process in the coming period as in recent years.
10. Despite the fact that international commodity prices entered a downward trend after the high-rated increase in May, they still remain at relatively high levels. Accompanied by the movements in exchange rates, these developments led to an increase in TL-denominated costs of commodities and other imported intermediary goods. The extent and duration of the *indirect* effects of unfavorable developments in imported input costs on consumer prices will chiefly depend on the course of demand conditions and expectations.
11. The second Expectations Survey data for June reveal that the ongoing fluctuations in financial markets have a negative impact on inflation expectations. Both the annual inflation expectations for the 12-month period and for the end of the 24-month period are above medium-term targets. The Monetary Policy Committee considered the deterioration of the expectations for the end of the 24-month period as a significant development.

#### ***The Monetary Policy Decisions of 20-25 June 2006***

12. In the ordinary meeting of the Monetary Policy Committee dated 20 June 2006, the Committee evaluated the data announced after the unscheduled meeting of 7 June 2006 and other developments and then, stated that there was no significant development that would affect the decision-making process

between 7-20 June 2006. Parallel to this evaluation, the Committee maintained the policy position of the previous meeting. In the brief announcement made after the said meeting, it was clearly stated that monetary policy would be conducted effectively in the event of an unfavorable development that might affect the medium-term inflation outlook. In this context, the Committee especially drew attention to medium-term expectations, international liquidity conditions and pricing behaviors, and announced that it will closely monitor developments in these factors.

- 13.** There were striking developments in international liquidity conditions and expectations in the days following the meeting of 20 June 2006. The increase in the movements in international financial markets continued to exert pressure on both exchange rates and medium and long-term interest rates in developing countries beyond the extent implied by economic fundamentals. Meanwhile, Turkey has been significantly influenced by these developments because of the structure of the portfolio held by non-residents. Furthermore, the Expectations Survey of 22 June 2006 reveals that medium-term expectations are continuing to increase.
- 14.** Following these developments, the Monetary Policy Committee gathered on 25 June 2006 to assess the developments and to discuss the measures to be taken. Members of the Committee have reached a consensus that recent volatility has the potential to affect the expectations and the risk perceptions, and thus disinflation process in the medium term. And the Central Bank will not allow this to happen. In this context, it is announced that the Central Bank will start deposit purchase auctions in order to reduce the excess New Turkish Lira liquidity in overnight money market via open market transactions, with the aim of increasing the effectiveness of the monetary policy decisions. Hence, the need for unscheduled Monetary Policy Committee meetings has been reduced. Governor Yılmaz has submitted the regulation, which has been drawn up for this purpose, to the Committee. Moreover, liquidity conditions in the foreign exchange markets have been thoroughly assessed and shrinkage of foreign exchange liquidity was identified. Due to the fact that an effectively operating foreign exchange market is a prerequisite for price stability, the Committee has expressed its full support for the effective intervention of the Central Bank Head-Office in order to provide foreign exchange liquidity via its instruments and mechanisms. At its meeting of dated 25 July 2006, the Committee has reviewed policy rates and has decided to further strengthen monetary tightening in order to improve medium-term inflationary expectations. Hence, the Committee has showed its determination to fight against inflation and stated explicitly that it is ready to do whatever necessary to achieve medium-term targets.

### ***Outlook***

- 15.** In the light of these decisions and under the assumption that the cautious attitude of monetary policy continues, the assessments made by the Committee on the medium-term outlook can be summarized as:
- 16.** The Committee foresees that domestic demand and growth will slow down in the second half of 2006. Though this downward trend is not expected to reach

stagnation level, it is predicted that growth rates will decline drastically compared to the first half of the year. Despite of the fact that economic activity is expected to recover gradually in the medium term, it will not be a surprise to witness low growth rates in the first half of 2007.

17. The forecasted contraction in demand will also contribute to the ease of the secondary effects of cost-oriented pressures on inflation. In this context, the impact of the latest movements in exchange rates on prices is expected to diminish from August onwards. Even if annual inflation is predicted to decline in August, inflation may display fluctuations in the fall due to intensive seasonal price adjustments. However, it is estimated that inflation will regain stability and that the main tendency will display a significant decline as of the second quarter of 2007 onwards.
18. The latest decisions of the Central Bank have increased the prospects for 2006 year-end inflation staying at a single digit-rate. More importantly, the effects of the latest exchange rate fluctuations on inflation are less likely to reflect in 2007. In this context, the Committee believes that the medium-term targets are achievable. Undoubtedly, these assessments rest upon the assumptions that fiscal discipline will continue, the consistency of incomes policy with the inflation targets will be maintained and expectations will be managed wisely.

### ***Risks and Policy Response***

19. The effects of the rises in energy and commodity prices and the rapid expansion of global output on inflation expectations in developed countries remained limited until recently. However, the upward tendency in inflation in these countries is considered an important risk factor. The monetary authorities of developed countries are growing more and more cautious about inflation and monetary policy. The Monetary Policy Committee deems the possibility of sustained global inflation concerns and continued monetary tightening process in developed countries as one of the most important risk factors.
20. In the event of the occurrence of risk that may lead to further decline in the global risk appetite and new fluctuations in Turkish financial markets, the Central Bank will not respond to the direct effects stemming from relative price changes, but will not allow any deterioration in expectations and general pricing behavior. Accordingly, the Central Bank will continue to employ all policy instruments effectively in the upcoming period, as before.
21. According to Committee members, another significant risk relating to the upcoming period is the possibility of deterioration in pricing behaviors. The studies that have been carried out at the Central Bank show that inflation targets have become a variable that is more frequently referred to in pricing decisions. Even though the upward tendency recently observed in inflation is temporary, the memories of high inflation are still very fresh. Therefore, a rise in the backward-looking indexation method or indexation to a variable other than the target in pricing behavior is a risk factor that should be avoided. The

Central Bank's response to this risk has been to introduce a fast and harsh monetary tightening package. Even if some short-lived deviations from the inflation target have become likely to occur in case of unpredictable shocks, the CBRT has given the policy response necessary for achieving the medium-term targets and will continue to do so in the future. If economic units made their medium-term plans according to the target inflation, the magnitude of the response would be smaller and it would take less time to get back on the main track. The primary objective of the Central Bank is to make the medium-term inflation expectations consistent with the targets, because only then would the inflation-targeting regime have been successful.

- 22.** The Committee has concluded that monthly price data are sometimes misinterpreted by economic units and that these misinterpretations can lead to irrational deteriorations in expectations. Especially in the recent period, it is observed that economic units increasingly tend to infer strong judgments on medium-term inflation without analyzing the price data in details. Therefore, in order to contribute to the accurate comprehension of monthly inflation data, a technical note on inflation developments will be published within two days following the announcement of price indices. The Inflation Report, assessing the reflections of recent economic developments on the medium-term inflation outlook and involving quantitative forecasts, will be published on 28 July 2006.
- 23.** Thanks to sustained public fiscal discipline and structural reforms, fiscal dominance is no longer a factor of concern with respect to monetary policy and they also help the Central Bank to use policy instruments more effectively. It should be borne in mind that price stability is a prerequisite not for only financial stability, but also for sustainable growth. The ease of uncertainties about inflation will enable the decline of long-term interest rates and this will have a favorable impact on both the financial sector and the real sector. In this framework, the Central Bank's focus on price stability contributes to social prosperity in the medium and long run.
- 24.** Much has been achieved on the way to macroeconomic stability in recent years. The implementation of prudent macroeconomic policies has played a significant role in these achievements. The environment of stability should continue in order to avoid a reversal in the gains achieved and to keep concerns 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 continuance 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 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.