Durmuş Yilmaz: Inflation in Turkey – an overview

Speech by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the press conference for the presentation of the Inflation Report, Ankara, 28 April 2006.

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Dear Press Members, Distinguished Guests,

The second issue of the Inflation Report, the leading communication means of the Inflation Targeting regime, which was put into effect as of January 2006, has been published on the web site of the Central Bank of Turkey today.

As repeatedly emphasized in our previous presentations and press releases, the impacts of monetary policy decisions on the economy manifest themselves during a certain period. In this context, on the way to achieve pre-announced inflation targets, central banks should analyze the developments that will affect the medium-term tendency of inflation and release inflation forecasts based on these analyses at certain periods within the framework of the inflation targeting regime. In the event of a remarkable deviation from the promulgated forecasts, explaining the reasons for such a deviation and the policy measures that should be taken to general public via inflation reports is of special importance under the transparency and accountability principles.

In this framework, the Central Bank published its first Inflation Report, which includes inflation forecasts and the analyses related to the economic outlook that lies behind the said forecasts in January 2006. With this report, the Central Bank, has, at the same time, shared with the public how it interprets the economic outlook with respect to inflation and monetary policy.

In this context, the second issue of the Inflation Report evaluates general macroeconomic developments so as to shed light on the likely tendency of inflation in the medium-term and, compare and contrast the updated assumptions on macroeconomic variables with those of the previous Inflation Report. The forecasts produced on the basis of the said assumptions are also shared with the public. In addition to all of this, the likely risks that may lead to an apparent downward or upward deviation in inflation forecasts are also explicated in the Report.

Content of the Inflation Report

Distinguished Guests,

The Inflation Report consists of six chapters.

In the first chapter, macroeconomic developments are summarized in the light of data released in the first quarter of 2006. The outlook for the supply-demand balance, productivity developments, international liquidity conditions and the risk premium, which are the determinants of the tendency of inflation in the medium-term and the inflation forecasts produced in compliance with this outlook also appear in the first chapter. Since it is considered that the control horizon of monetary policy involves a timeframe of one and a half years as in the previous Inflation Report, forecasts are presented so as to cover the remaining three quarters of 2006 and the first three quarters of 2007.

Moreover, the outlook regarding the course of the factors that pose risk to achieving the inflation target, which are outside the area of impact of monetary policy is summarized in the introduction section and the likely policy reaction against such risks is discussed. These risk factors are listed as the course of oil prices, housing price increases, the acceleration in price increases of those items, which are determinant in the inflation of the goods group, such as fresh fruits, oil, basic metals and gold, global risk appetite and international liquidity conditions.

Detailed analyses of developments in inflation, supply-demand, the financial sector and public finance, which have been examined within the framework of the information they contain relating to the medium-term tendency of inflation are presented in the following four chapters.

In the last chapter of the Inflation Report, updated assumptions on fundamental macroeconomic variables are compared and contrasted with the assumptions of the previous Inflation Report and inflation and the output gap forecasts produced on the basis of these assumptions are analyzed.

Furthermore, the likely risks that may lead to an apparent upward or downward deviation in inflation forecasts are explicated in detail.

In this Inflation Report, a number of boxes have been prepared in order to shed light on certain subjects of interest as in the previous Report. For instance, the impacts of differentiation in productivity ratios in the tradable and non-tradable sectors compared to the Euro zone on relative prices and real exchange rate behavior in the process of convergence with the European Union are analyzed in one of the boxes. Moreover, in addition to the box in which international gold prices and the impacts of these on the CPI are analyzed, the Report also contains a box in which the targets and realizations relating to inflation and Net International Reserves are evaluated within the context of IMF conditionality.

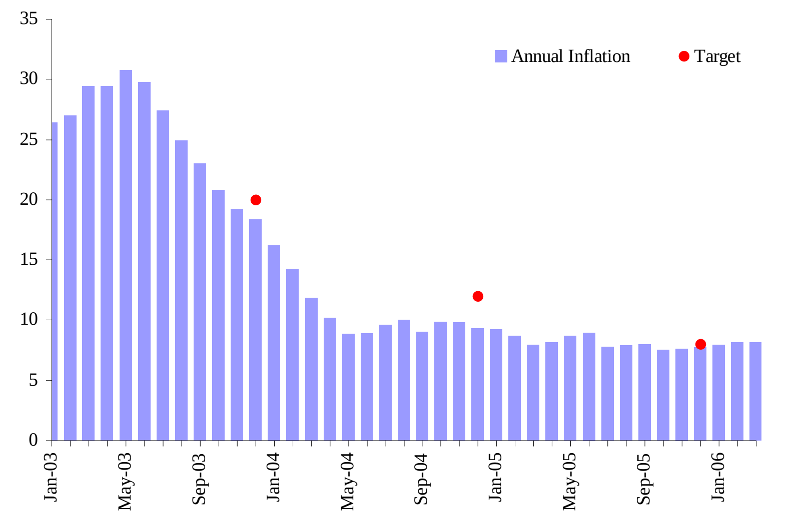
Distinguished Guests,

After this general overview, I would like to summarize the evaluations and the inflation forecasts of the Central Bank in the latest Report, which will be published on our web site today.

Inflation developments

In the first quarter of 2006, the fall in inflation displayed a slowdown tendency in line with our predictions in the previous Inflation Report and the annual rate of increase in consumer prices was realized as 8.16 percent as of the end of March 2006. This slowdown stems from the base effect created by the price increases that have realized at historically very low levels due to the reduction in the Value Added Tax (VAT) rates of food, health and education items made in early 2005 (Graph 1).

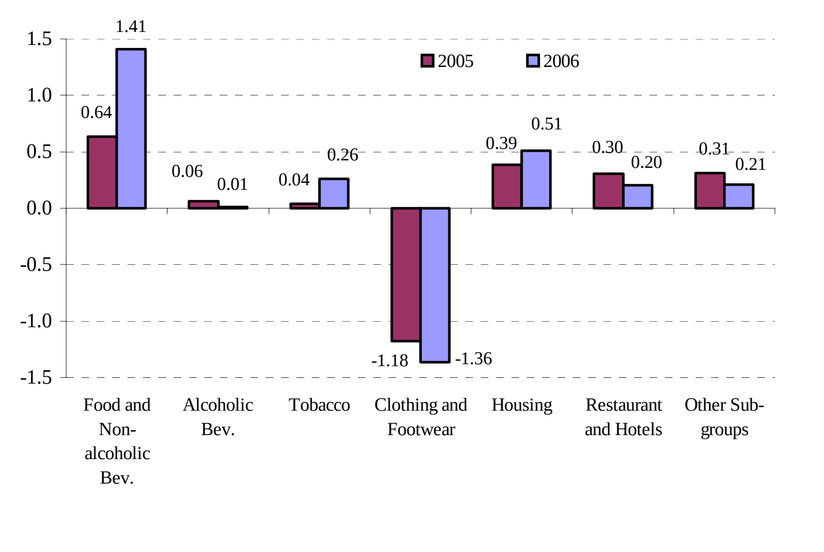
Graph 1. End-year Inflation Target and Annual CPI Inflation (Percentage Change)



Source: TURKSTAT.

However, the sole reason for the realization of inflation above the path consistent with the end year inflation target in the first quarter of the year is not the said base effect. When the contribution of sub-items to first quarter inflation is analyzed, it is observed that the course of prices of unprocessed food products, which increased beyond expectations, tobacco products and services played a leading role in the said rise. Nevertheless, high-rated seasonal discounts in clothing prices due to demand and competitive conditions limited the increase in consumer price inflation (Graph 2).

Graph 2. The Contribution of Sub-items to First Quarter Inflation (Point)



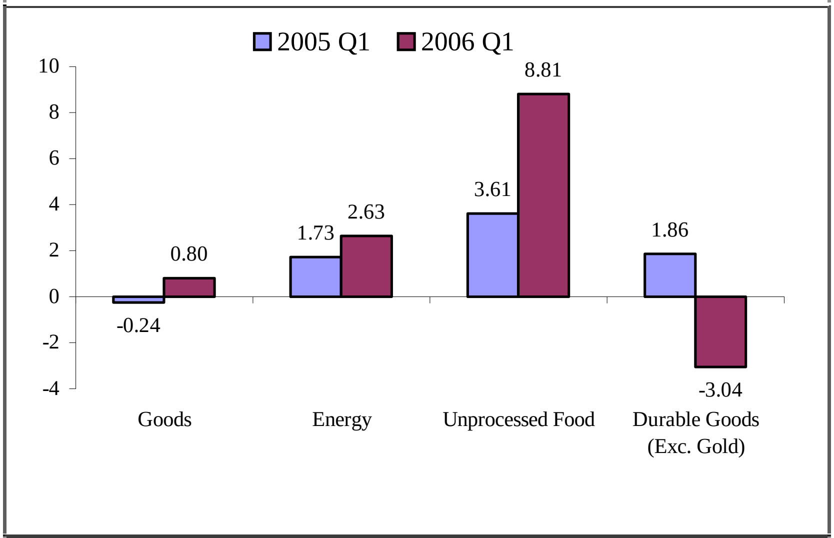
Source: TURKSTAT, CBRT.

Dear Guests,

Classifying goods and services group, price increases in goods group gained pace, while the services group inflation declined, except rents item, in the first quarter of 2006.

Along with energy prices, the prices of unprocessed food products, which increased significantly in the first quarter of 2006, compared to the same period of the previous period, became the determinant in the rise in prices of the goods group (Graph 3).

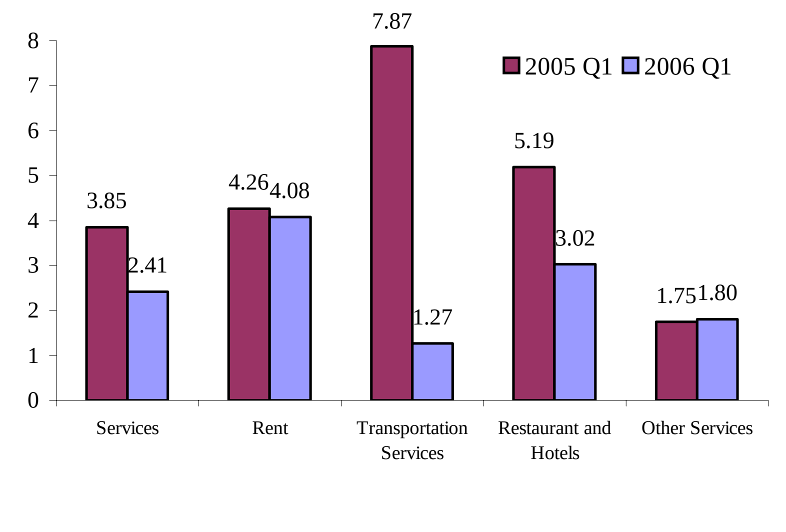
Graph 3. Prices of Goods (Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

The developments in services group prices indicate that the prices in restaurant and hotel services as well as transportation prices remained considerably below the rates of increase of the same period of the previous year. Nevertheless, annual inflation rates in services, which are referred to as 'labor intensive services' and whose prices cannot be directly managed and are not directly influenced by energy prices, have followed a stable course in the past year. Moreover, the realization of price increases in rents at almost the same rates of the previous year due to the lack of immediate housing supply against increasing housing demand in the first quarter of 2006 also points to the unfavorable impact of the said prices on consumer prices throughout the year. In this context, demand developments towards services and productivity developments are being carefully monitored and we maintain our scrutiny of these developments (Graph 4).

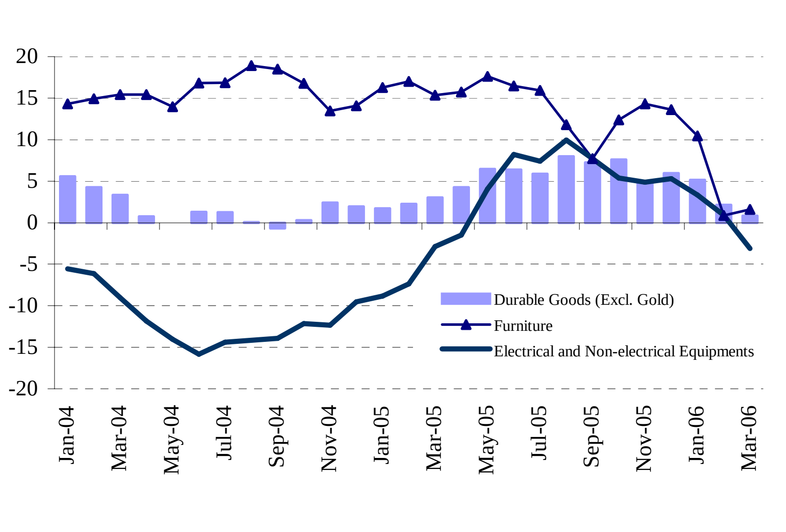
Graph 4. Prices of Services (Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

Analyzing the course of prices in durable consumption goods, excluding gold prices, that have continued their high-rated upward trend within the framework of developments in international markets, the annual rate of increase of the said prices entered a downward trend as of August and this trend continued to accelerate in the first quarter of 2006. A reverse in the tendencies of both furniture prices, which may be an indicator of consumption demand and prices in the electrical and non-electrical devices group, including technology-intensive goods open to competitiveness in general and susceptible to the exchange rate developments as well, are major determinants of this trend (Graph 5).

Graph 5. Prices of Durable Goods (Excluding Gold) (Annual Percentage Change)

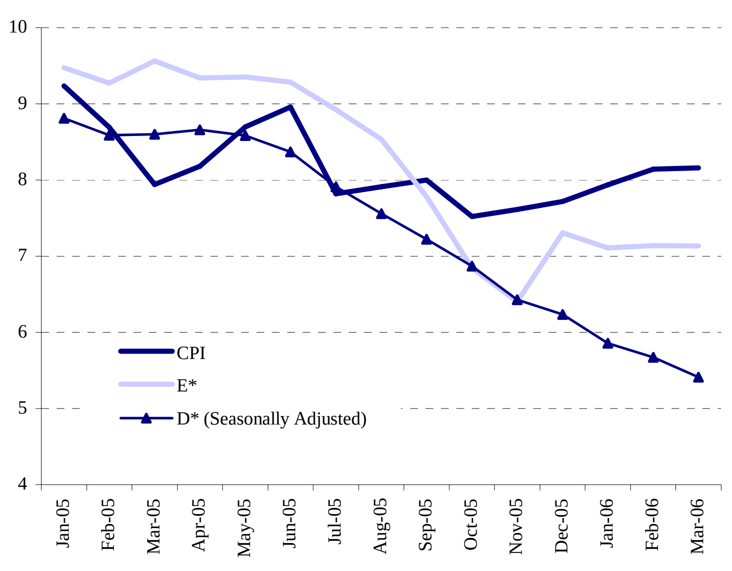


Source: TURKSTAT, CBRT.

Considering the fact that seasonal price movements are determinant in consumer prices, it will be helpful to analyze the Special CPI Aggregates (SCA), excluding seasonal products, with respect to the course of inflation.

The decline in the annual rate of increases in the SCA-E* index that has been continuing since the beginning of 2005, which is calculated by excluding seasonal products from the SCA-E index - excluding energy, alcoholic beverages and tobacco products, had slowed down by the first quarter of 2006. On the other hand, it is observed that the downward trend in the seasonally adjusted SCA–D* index, which is calculated by excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold, continued in the first quarter of the year as well and the main trend of inflation was downwards (Graph 6).

Graph 6. CPI and Special CPI Aggregates (E* and D*)
(Annual Percentage Change)



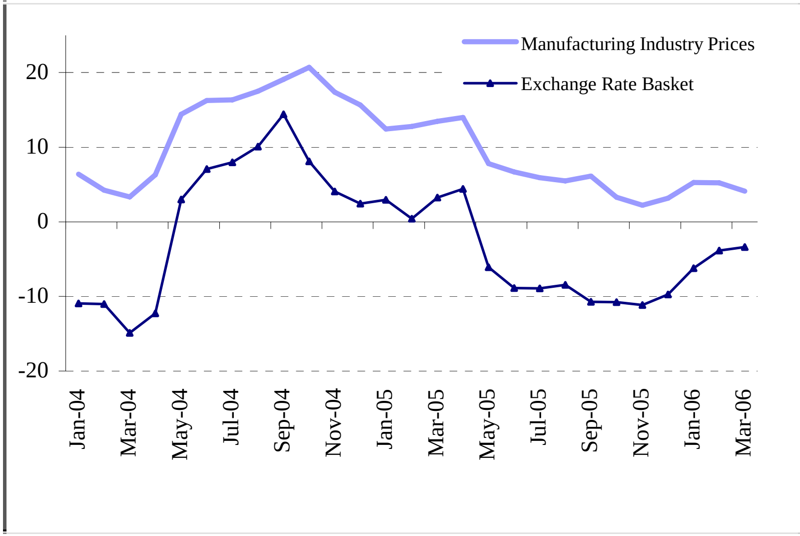
E*: CPI excluding energy, alcoholic beverages, tobacco products and seasonal products

D*: CPI excluding energy, alcoholic beverages, tobacco products, unprocessed food and gold

Source: TURKSTAT, CBRT.

Producer prices rose by 2.48 percent in the first quarter of 2006. The Producer Prices Index, which is calculated by excluding tax, indicates that manufacturing industry prices, comprising a significant part of the index, have become more susceptible to raw material prices and exchange rate developments compared to previous years (Graph 7).

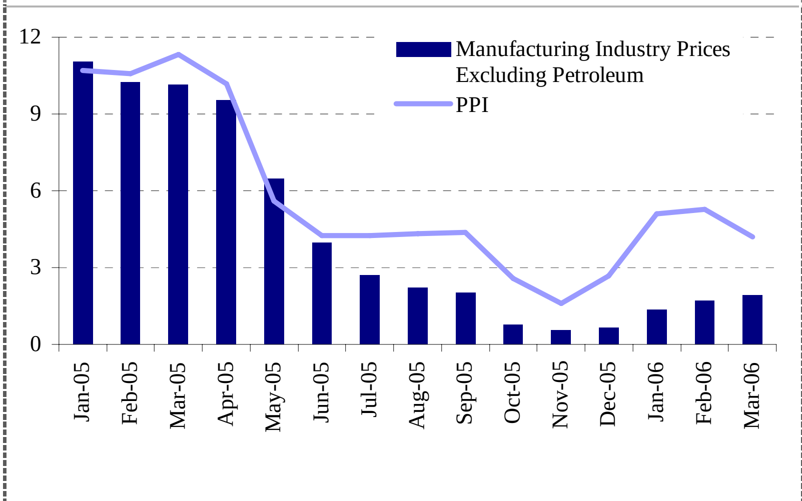
Graph 7. Manufacturing Industry Prices and Exchange Rate Basket (0,5 USD + 0,5 Euro) (Annual Percentage Change)



Source: TURKSTAT, CBRT.

The sector, in which the said effect is clearly perceived within the PPI, is the petroleum products sector that is subject to high taxes. Excluding the said effect, the annual rate of increase in manufacturing industry prices is maintaining its low-level trend, albeit its slight upward tendency (Graph 8).

Graph 8. PPI and Manufacturing Industry Prices Excluding Petroleum Products (Annual Percentage Change)



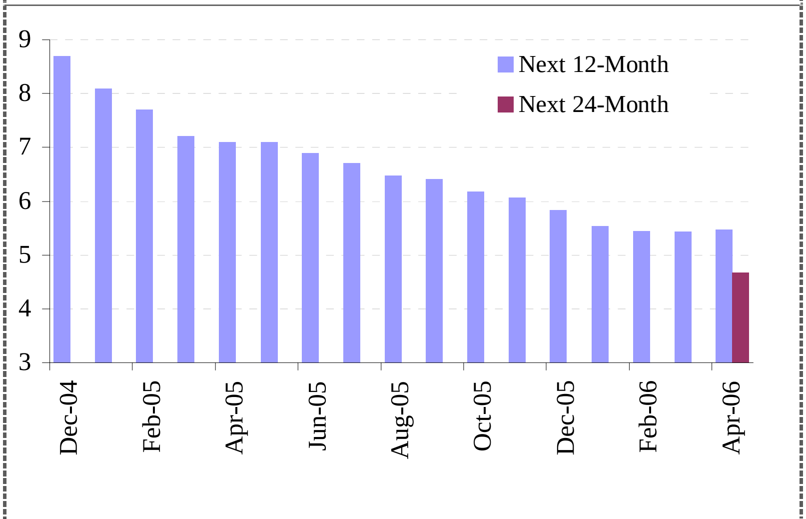
Source: TURKSTAT, CBRT.

Distinguished Guests,

Inflation expectations are determinant on inflation realizations in view of being the basis for both pricing behavior and wage adjustments. Therefore the developments in these expectations play an important role in Central Bank analyses and evaluations. In this framework, analyzing the inflation expectations for the next 12 months and 24 months as of April, the following points emerge:

Though consumer inflation expectations for the next twelve months have declined, the rate of decline has been slowing down significantly since February and expectations have to some extent been following a horizontal course. The fact that long-term consumer expectations relating to the next 12 and 24 months are slightly above the targets is interpreted as a development that requires prudence with respect to the falling inflation process. Nevertheless, the course of longer-term expectations at low levels is an encouraging development as regards the success of inflation targeting (Graph 9).

Graph 9. CPI Expectations Regarding Next 12 and 24 Month Periods
(Annual Percentage Change)



Source: CBRT.

Supply and demand developments

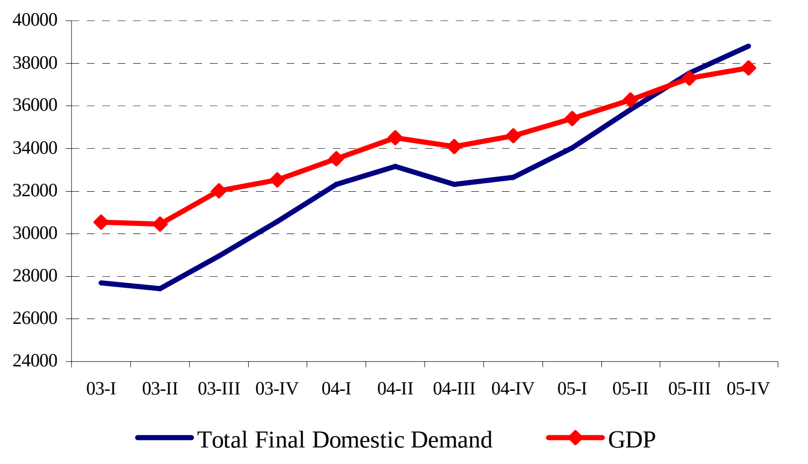
Supply-demand balance

Distinguished Guests,

At this point, I would like to touch on our evaluations relating to supply and demand developments in the light of national income data released at the end of March.

In the last quarter of 2005, Gross Domestic Product (GDP) increased by 9.5 percent compared to the same period of the previous year. Hence, GDP growth was realized as 7.4 percent throughout 2005. The ongoing structural reform process along with the implementation of tight monetary and fiscal policies have enabled the strengthening of economic fundamentals, characterized as a decline in the risk premium, reduction in real interest rates and appreciation of the New Turkish lira (YTL) against foreign currencies, which have been the main determinants of rapid growth in the total domestic demand in 2005. Within this framework, total final domestic demand increased by the high rate of 19.1 percent in the last quarter of 2005 compared to the same period of the previous year. Analyzing by quarterly periods, seasonally adjusted data also point to an ongoing rapid growth tendency in total final domestic demand in the last quarter of 2005 (Graph 10).

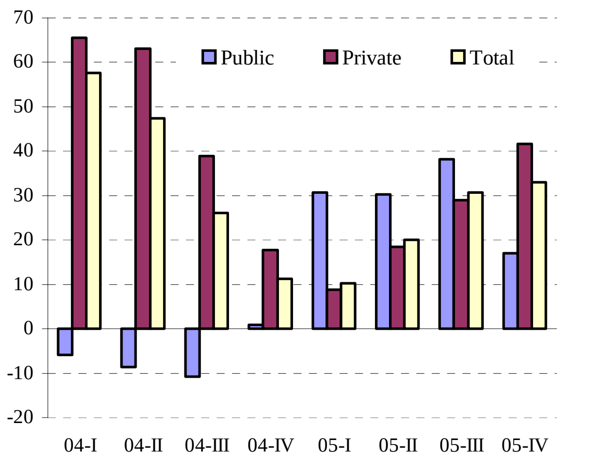
Graph 10. GDP and Total Final Domestic Demand (Seasonally Adjusted)



Source: TURKSTAT, CBRT.

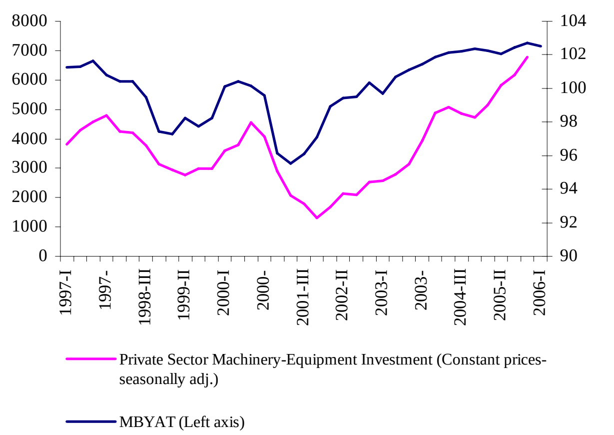
Analyzing by demand components, total consumption and total investment expenditures made a high contribution to GDP growth by 5.8 and 5.7 percentage points, respectively. While private investment expenditures maintained both its machinery-equipment and construction investment-originated growth trend in the last quarter of the year, public expenditures provided an investment-based support to economic growth during the same period. Accordingly, both public and private-sector-originated high increases in total investment expenditures are still continuing (Graph 11). The index produced by the aggregation of indicators relating to investments also points to an ongoing upsurge in machinery-equipment investments (Graph 12). Moreover, the high-rated increase in long-term credit use from abroad during the January-February period compared to the same period of the previous year indicates that investment-originated growth prevailed in the first quarter of 2006 as well (Annex Graph 1).

Graph 11. Fixed Capital Investments (Annual Percentage Change)



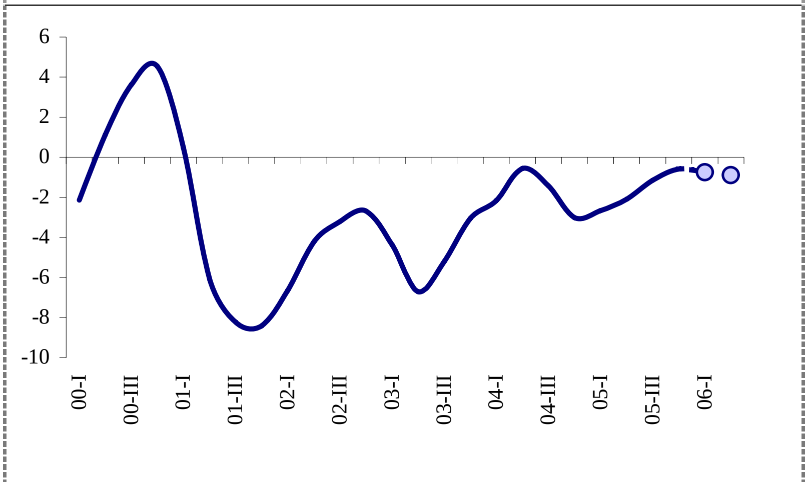
Source: TURKSTAT, CBRT.

Graph 12. Private Sector Machinery-Equipment Investments and Investment Index (MBYAT)



Despite rapid growth in the total final domestic demand and the GDP, the current production tendency signifies a level that does not impose any pressure on prices. Hence, estimates for the output gap indicate that recent trend in economic growth does not pose a threat with respect to inflation (Graph 13). The factors underlying this evaluation can be listed as follows: (i) Analyzing the supply-side sources of growth, continuance of productivity gains, which is a key element of non-inflationary growth, enables the reduction in unit labor costs, thus restricts the impact of the rises in other costs. (ii) The demand-side sources of growth points to an increasing share of investments in the GDP. The ongoing strong growth trend in investment expenditures limits inflationary pressures through its support for the increases in partial labor productivity via capital deepening. Accordingly, the composition of domestic demand secures the simultaneous achievement of rapid growth and disinflation. (iii) Although the strong position of the YTL against foreign currencies is a factor that supports domestic demand growth, it restricts the impact of rapid growth on prices not only by its direct effect on prices but also by stimulating investment demand, which in turn induces productivity gains.

Graph 13. Output Gap (Percent)



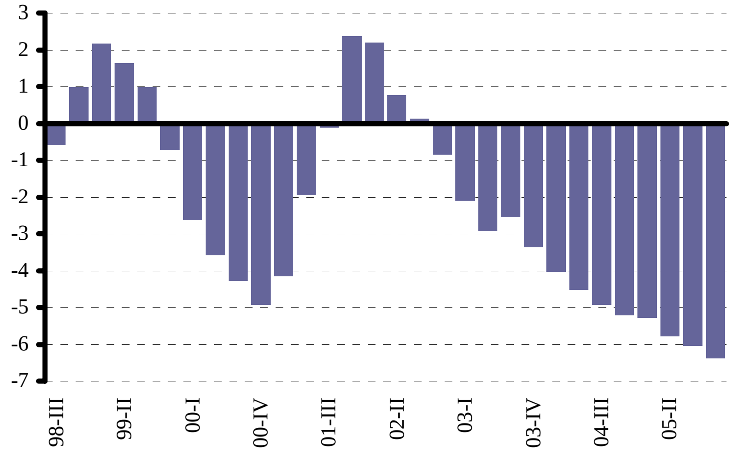
Source: CBRT.

Despite the fact that the recent data provide signals for an ongoing strong course of domestic demand, within the framework of non-inflationary rapid growth analysis explained above, the output gap is expected to support the disinflation process in the first half of 2006 as well. Nevertheless, our view that the contribution of supply-demand conditions to the disinflation process has diminished is still valid.

Foreign demand

The current account, which was USD 15.6 billion in 2004, reached USD 23.1 billion in 2005, realizing 6.4 percent of the GNP (Graph 14). The upward trend in the current account deficit continued in the first two months of 2006.

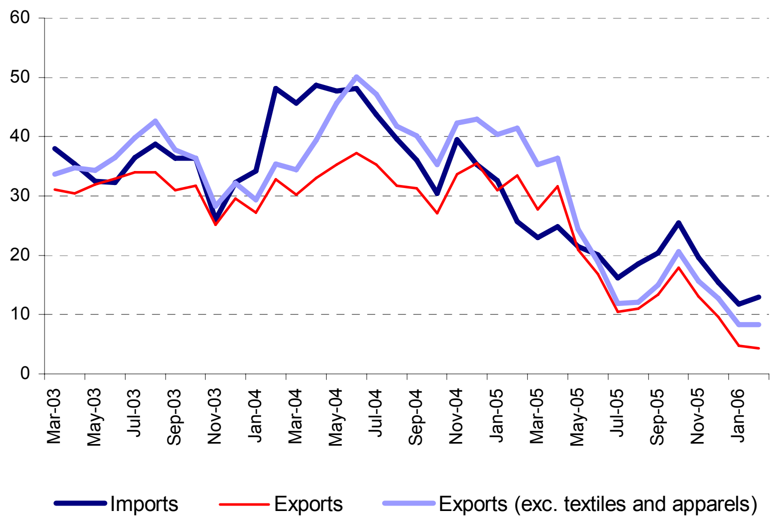
Graph 14. Current Account Balance/ GNP
(Annualized, Percentage)



Source: CBRT.

In 2005, while the rates of increase of both exports and imports weakened compared to 2004, the rate of increase in exports remained well below the rate of increase in imports in the second half of the year. The said tendency continued in the first two months of 2006 as well (Graph 15). The decline in textiles and apparels exports on an annual basis since November 2005 has had an unfavorable impact on general export performance. While rapid economic growth leads to an increase in the imports of intermediary goods, the rises in oil prices boost the amount of imports infused terms.

Graph 15. Imports and Exports (*)
(Billion USD, Annual Percentage Change)



*Quarterly moving averages.

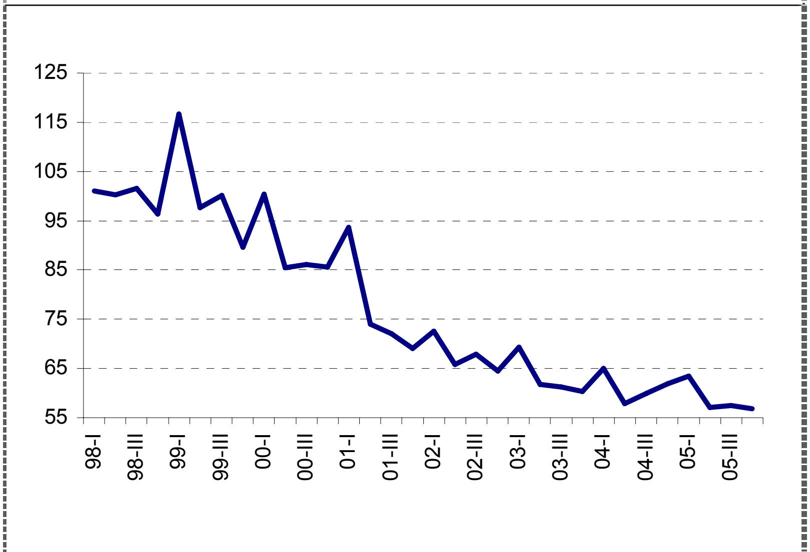
Source: TURKSTAT.

It is expected that the current account deficit will not pose any risk with respect to economic stability and the inflation target in the short-term. Along with growth in the share of foreign direct investments that have gained pace with privatization revenues, the increase in the share of long-term credits in the credit composition of the banking sector and the private sector eases concerns about the sustainability of the current account. It is predicted that foreign direct investments, which reached USD 8.6 billion in 2005 (2.4 percent of GDP), will prevail at high levels in 2006 as well due to the continuance of privatization revenues and company acquisitions. Moreover, the process of convergence with the European Union is expected to ensure the continuance of international capital's interest in Turkey.

Costs

While productivity rose at a high rate in the private manufacturing industry, real unit wages dropped by 8.2 percent compared to the same period of the previous year due to the decline in real wages (Graph 16). The persistence of the drop in real unit wages became one of the leading factors in the continuation of the disinflation process.

Graph 16. Unit Real Wage Index in Manufacturing Industry (1997=100)

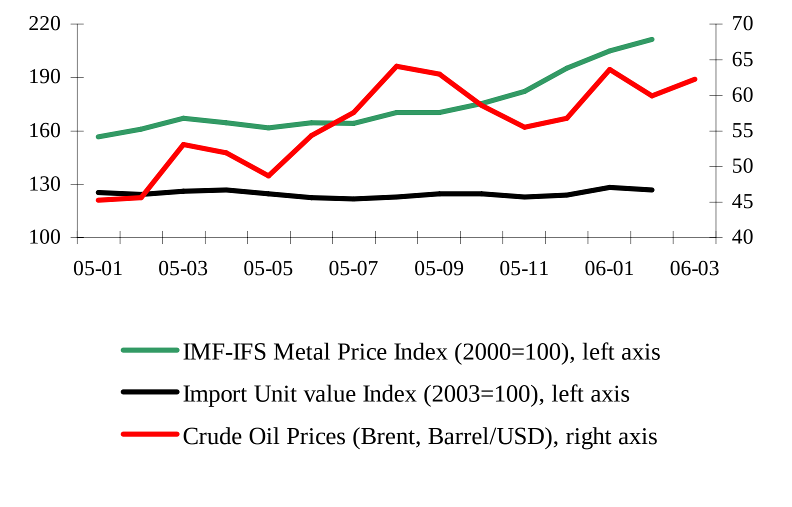


Source: SPO, TURKSTAT and CBRT.

In 2006, in the event investments and employment in the manufacturing industry follow the same course as the previous period, the continuance of productivity increases may be expected. Meanwhile, the salaries of civil servants and minimum wage increases point to a rise in wages above inflation.

The unfavorable course in raw material prices, another significant component of costs, still persists. Crude oil prices exceeded their historical peak figure experienced during Hurricane Katrina by the 25th of April and reached USD 73.3 per barrel. OPEC's decision to leave its quota unchanged at its meeting of the 8th of March, the low level of unused capacity in the sector and uncertainties about leading oil producing countries such as Nigeria and Iran led to an increase in oil prices. Despite new production capacities are expected to be introduced, the International Energy Agency's (IEA) expectations for the growth trend in crude oil demand, which are above those of 2005, strengthen the probability that oil prices will remain high throughout 2006. In the meantime, while the high global growth tendency pushes metal prices upwards, the increase in the interest of investment funds to the sector investment tools becomes the determinant in the upsurge in metal prices above expectations. In the light of these developments, crude oil prices continue to be a risk factor with respect to inflation.

Graph 17. Chosen Indicators Relating to Crude Oil Prices



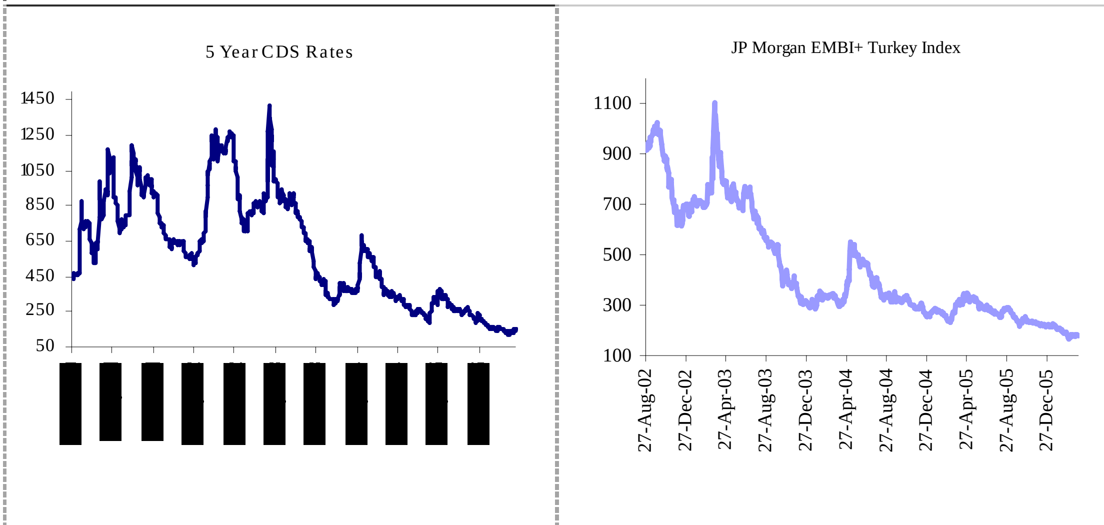
Source: IFS, TURKSTAT, Bloomberg.

Financial markets and financial intermediation

Distinguished Guests,

The course of international liquidity conditions and the risk premium in the first two months of the year has been in favor of developing countries. In March, the favorable course in risk premium came to a halt because of the deterioration in the global risk appetite and the increase in the perceptions of uncertainty about the interest rates of the Bank of Japan. Nevertheless, the ongoing successful conduct of budget performance became the most significant development that limited the tendency of deterioration in expectations (Graph 18).

Graph 18. Indicators Relating to Risk Premium



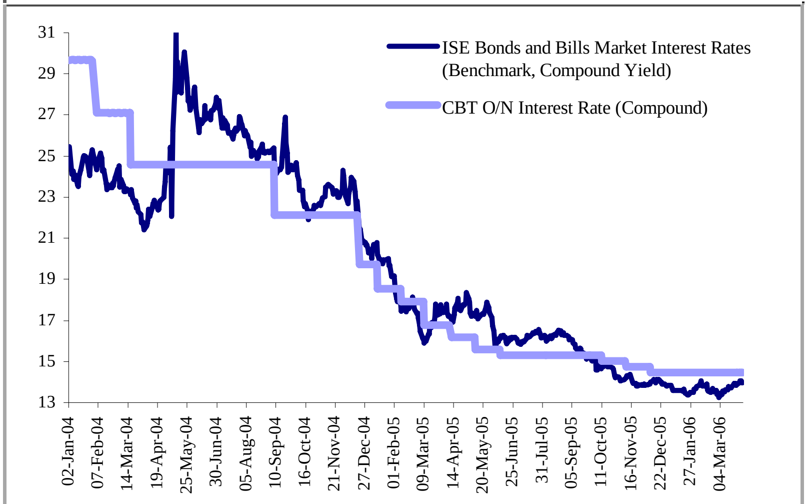
Source: Bloomberg.

Interest rates remained unchanged in the first quarter of 2006. However, a reduction by 25 basis points was made in April. The consistency of data relating to inflation and economic activity, which were released in the first four months of the year, with Central Bank forecasts specified in the first

Inflation Report allowed us to act in compliance with the policy perspective that was shared with the public.

The benchmark interest rate in the ISE, which has been realized under the overnight borrowing rate since October 2005, displayed a slight increase in March due to the stagnation in interest rate reductions, global liquidity conditions and domestic uncertainties (Graph 19).

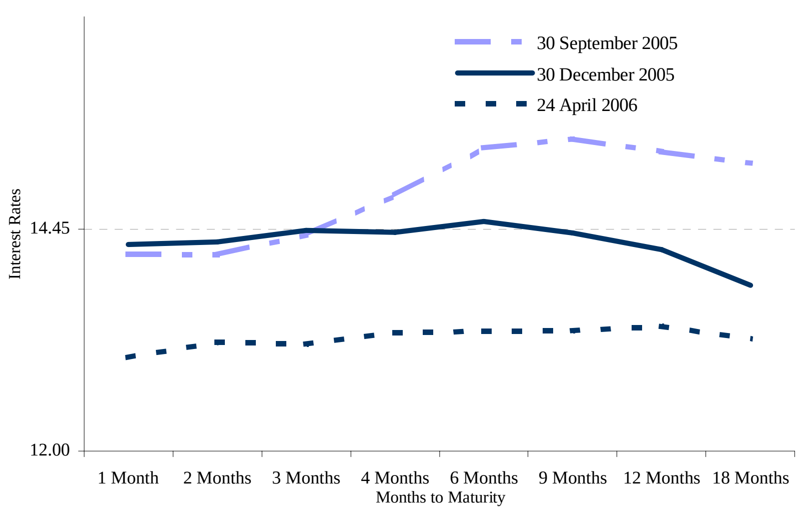
Graph 19. The Developments in Interest Rates



Source: ISE, CBRT.

Analyzing the yield curve that shows interest rates in the ISE with different maturities, the interest rates have been realized at a lower level in each maturity as of 24 April 2006 compared to the end of the previous year. This development stems from the expectations that the downward tendency in inflation will continue in 2006 as well. Nevertheless, the more horizontal course of the longer maturity end of the yield curves compared to the previous periods confirms the cautious attitude of economic agents towards their future risk perceptions in the said period (Graph 20).

Graph 20. Yield Curves



Note: Line 14,45 corresponds to the composite interest rate of the overnight interest rate of 13.50.

Source: ISE.

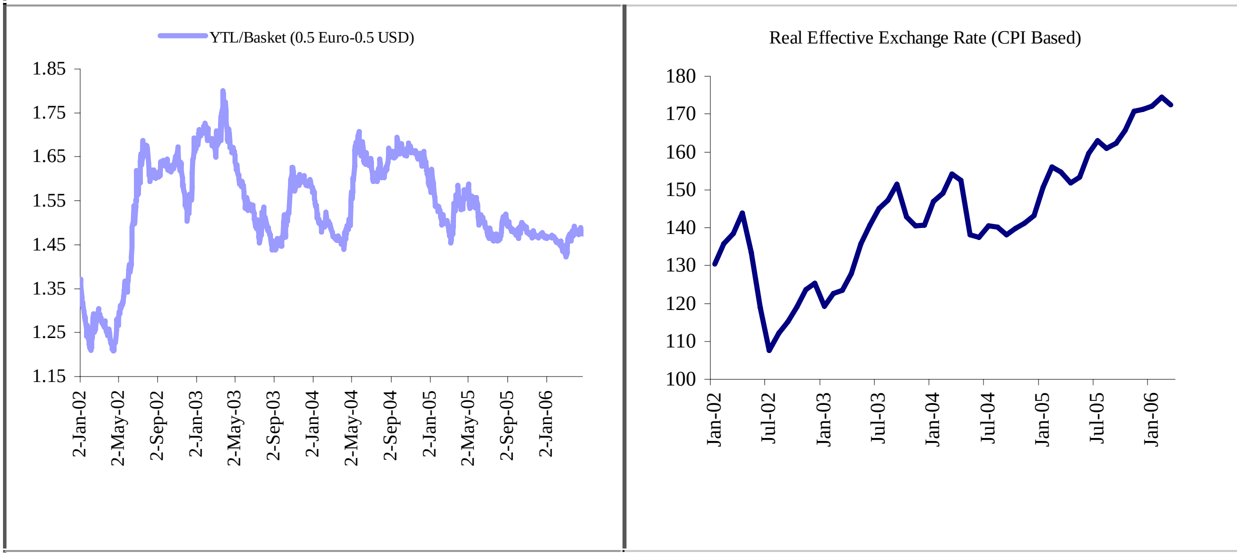
The stagnation in the downward tendency of the risk premium was reflected on the real interest rate as well and real interest rates that are calculated by using benchmark securities interest rates and twelve-month ahead inflation expectations obtained from the CBRT Expectation Survey followed a relatively horizontal course in the first quarter of 2006 (Graph 21).

Graph 21. Developments in Real Interest Rates (According to ISE Benchmark Interest Rate and Twelve-Month Ahead Inflation Expectations)

Source: ISE, CBRT.

The appreciation of the New Turkish lira continued in the first two months of 2006. In March, however, the New Turkish lira depreciated against the basket consisting of Euro and USD due to the rise in the risk premium (Graph 22).

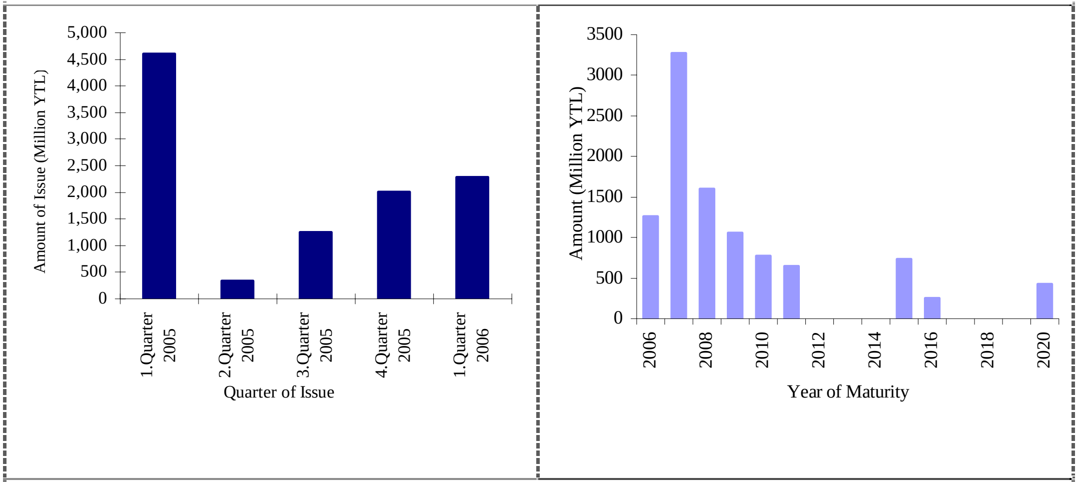
Graph 22. Exchange Rate Developments



Source: CBRT.

It is observed that the stability in YTL-denominated bond issues by foreign banks, an indicator of demand for YTL, has a tendency to continue. In the first quarter of 2006, there was no remarkable change in the maturity structure of current securities compared to the last quarter of the previous year (Graph 23).

Graph 23. YTL-Denominated Bonds Issued by Foreign Banks



Source: CBRT.

Public finance

Distinguished Participants,

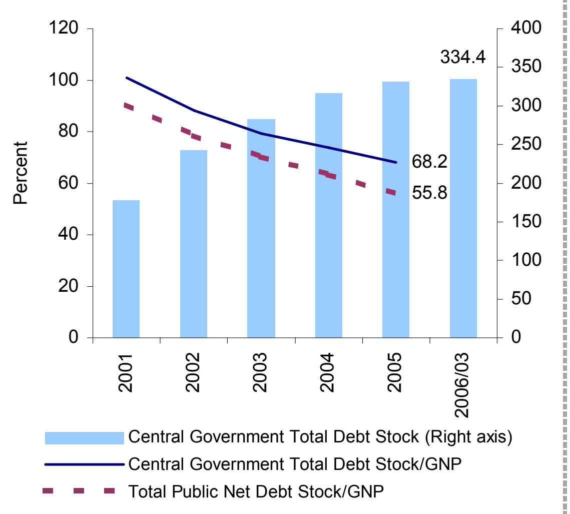
It is well known that developments in debt stock are of great importance with respect to managing the expectations of economic agents and, thus, the course of the risk premium. In this framework, these developments are closely monitored as regards monetary policy and inflation.

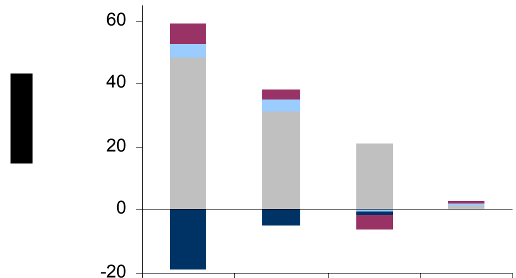
In the current period, the rate of increase in the debt stock slowed down significantly due to decreasing interest payments and the high primary surplus and the downward tendency in the ratio of public debt stock to GNP continued. It is observed that the same trend still continues even when parity and exchange rate effects are excluded from the change in debt stock.

Additionally, it is considered that the structure of debt stock has become stronger against the risks in the said period. Decreasing the susceptibility of debt stock towards exchange rates and limiting its susceptibility to interest rates on one hand, and the risk reduction in debt roll-over owing to the extension of the borrowing maturity and the strengthening of cash reserves on the other hand, are the factors that support our mentioned assessment (Graph 24).

Graph 24. Public Debt Stock Indicators (Billion YTL)

Public Debt Stock Indicators	The Analysis of the Change in the Central Government's Overall Debt Stock





	2003	2004	2005	2006/03*
Parity Effect**	6.2	3.0	-4.8	0.7
Exchange Rate Effect***	-18.8	-4.6	-0.8	0.0
Foreign Debt Net Increase	4.0	4.1	-0.6	0.7
Domestic Debt Net Increase	48.8	31.2	21.1	1.4

* It shows the change compared to 2005.

** It shows the external debt changes resulting from movements in USD/Euro and USD/SDR parities.

*** It indicates the changes resulting from movements of New Turkish Lira against USD.

Note: It represents the growth in the net increase in debt stock excluded from exchange rate and parity effects. The parity effect is calculated merely for the external debt. Each component of the change in debt stock is calculated as billion YTL. The sum of components corresponds to the nominal change in the overall debt stock expressed in terms of YTL.

Source: Treasury, CBRT.

Medium-term forecasts

Current stance, short-term outlook and the assumptions

Current stance relating to real sector variables that constitute the basis for the forecasts presented in the previous Inflation Report have been preserved in this Report to a great extent. Despite rapid growth in domestic demand in the last quarter of 2005, the ongoing increase in the ratio of investment expenditures to GDP eased the pressures on inflation imposed by the increase in demand by pushing the production capacity upwards. Moreover, continuing productivity proceeds limited the increase in costs, thus limiting the pressure on inflation. While producing forecasts, the short-term outlook relating to domestic supply and demand conditions was developed in the light of these findings.

Real interest and real exchange rate variables, which determine the relationship of supply-demand conditions to inflation and constitute the starting point of the monetary transmission mechanism, are also significant components of the assumption set that constitute the basis for medium-term forecasts. It is assumed that in the current situation, real interest rates are not at a level that can exert pressure on credit increases and demand conditions. Nevertheless, under a main scenario in which the current program will continue to be implemented, macro and political stability will not deteriorate, structural reforms and, accordingly, long-term capital inflows as well as productivity increases will continue, it is assumed that the New Turkish lira will retain its strong position and will continue to support the decline in inflation.

In the first Inflation Report of 2006, it was foreseen that though the falling inflation process would enter a stagnation period in the first quarter of the year, it would follow a downward tendency as of the second quarter of the year, unless an unfavorable exogenous development happened. While the reduction of VAT in the textile, ready-made clothing and leather sectors to 8 percent from 18 percent in March was a development that reinforced the forecast that inflation would re-enter a downward tendency in the second quarter of the year, rapid increases in oil prices in the recent period forewarned that the said forecast should be handled cautiously. While producing forecasts, this information was also added in the framework of the short-term outlook.

Besides, the price dynamics in services sector, mainly the rent sub-item, continue to play a critical role with respect to achieving the year-end inflation target. Though the contribution of the rises in the rent sub-item to 2006 inflation is forecasted to be about one point, a scenario, in which this periodic pressure on CPI inflation will decreasingly persist throughout 2007, is considered.

Forecasts relating to fundamental macro variables of the Euro zone, such as interest rates, inflation and growth, analyses concerning international commodity prices and the likely course of global liquidity conditions comprise our assumptions of the external world that constitute the basis for our forecasts. European growth figures were slightly revised upwards within the framework of the "Consensus Forecast" results and the assumption that European Union Harmonized CPI inflation would almost reach the targeted two percent in 2006 and 2007 was retained. Moreover, the news that the European Central Bank would presumably continue to raise interest rates was considered while producing our inflation forecasts. Along with those of the Euro zone, monetary policies of other developed countries were also carefully monitored during the forecast-making process as regards foreseeing the course of international liquidity conditions.

Following a relative stable course, crude oil prices entered an upward trend in the last period. Due to the difficulty in making a precise forecast relating to oil prices, while producing inflation forecasts under the main scenario, it was assumed that oil prices would follow a horizontal course at their current level. Hence, a level above that assumed in the first Inflation Report was foreseen. In this context, the assumptions about oil prices were updated upwards while producing forecasts.

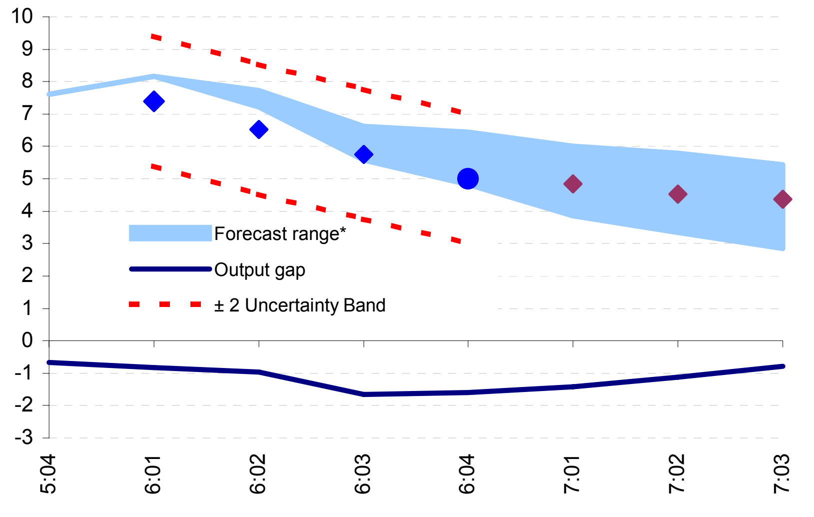
Finally, a number of assumptions were made on the likely course of the risk premium throughout 2006 and 2007. The favorable outlook for the course of the risk premium specified in the first Inflation Report was preserved for the first two months of 2006. However, both the deterioration tendency in the global risk appetite and the increase in the uncertainty perceptions about the Bank of Japan's liquidity policy led to a rise in the risk premium in March. Nevertheless, in line with the easing of uncertainty perceptions during the last period, the forecasts given in the last chapter of the Report are based on the projections that the change in global liquidity will be moderately realized and international liquidity conditions will not experience any sudden changes.

Interpretation of forecasts

Distinguished Guests,

As I emphasized in the introduction to my speech, it takes a certain period of time for the monetary policy decisions to manifest their effect on the economy. Taking this fact into consideration, the Central Bank establishes its monetary policy under a medium-term perspective and focuses on the consistency of future inflation with the target, not that of today's inflation. In this framework, since it is considered that the average control horizon of monetary policy on the economy involves a period of time of one and a half-years, the forecasts are presented so as to include the remaining three quarters of 2006 and the first three quarters of 2007.

Graph 25.Inflation and Output Gap Forecasts



*The probability of inflation staying within the forecast range is 70 percent.

♦ The path 'consistent with the target' which is announced in 5 December 2005 ''General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy' and constitutes the base for the principle of "accountability".

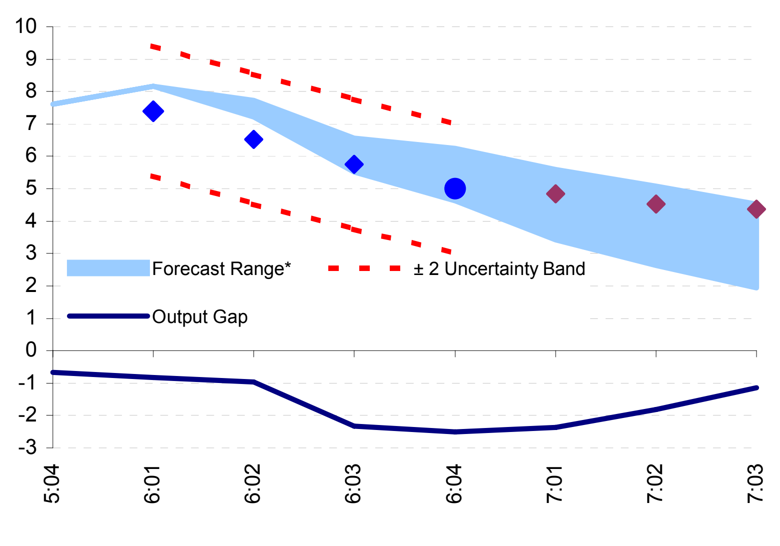
• 2006 end-year point target.

♦ The path consistent with the 2007 end-year target, under contemporary data set.

The inflation forecasts given in Graph 25 were made under the base scenario developed on the basis of the assumptions and short-term outlook mentioned above, and the stance under which the Central Bank will progressively cut its policy interest rates in the forthcoming period. Accordingly, it is forecasted, in the light of current information, that inflation will be realized between the 4.8-6.4 percent at the end of 2006 and between the 2.9-5.4 percent at the end of the first nine months of 2007. In other words, according to the forecasts that have been produced within the framework of today's data set, inflation will regain a downward course starting from the second quarter of the year. This tendency will become more apparent as of the third quarter and year-end inflation will be realized close to the target (Graph 25).

The Graph also displays forecasts on the output gap that constitute the basis for the inflation forecast. Accordingly, the output gap will continue to remain negative throughout 2006. In other words, the contribution of overall demand and capacity conditions to the falling inflation process will continue in 2006 as well, albeit with a decline compared to the previous years. The projection that total demand for domestic goods will remain relatively limited due to the negative contribution of the foreign demand, despite the stable increase in domestic final demand throughout 2006, underlies these findings (Graph 25).

Graph 26. Inflation and Output Gap Forecasts (Constant Interest Rate)



* The probability of inflation staying within the forecast range is 70 percent.

♦ The path 'consistent with the target' which is announced in 5 December 2005 ''General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy' and constitutes the base for the principle of "accountability".

• 2006 end-year point target.

♦ The path consistent with the 2007 end-year target, under contemporary data set.

In Graph 26, the forecasts that have been produced under a main scenario are presented - in which the current stance, the short-term outlook and the assumptions relating to the fundamental variables - the framework of which are given above -are faithfully preserved; however, the policy interest rates are maintained as unchanged for one year starting from today.

In contrast to the previous scenario, the path of policy interest rates has not been determined by a medium-term approach, but has been handled as an exogenous assumption. Under the said assumption, output gap becomes clearly negative as of the third quarter of 2006 and the contribution of demand conditions to falling inflation increases. According to the projections produced under such conditions, inflation drops rapidly compared to the previous scenario and is realized between a 1.9 - 4.5 percent by the third quarter of 2007. Thus, the possibility of inflation falling evidently under the path consistent with the target increases (Graph 26).

Risk elements

Distinguished Participants,

It should be emphasized once more that the forecasts that I have presented were produced under a main scenario, which was developed on the basis of the above-mentioned assumptions and short-term outlook in the light of current data. In the event of a possible threat to the medium-term inflation outlook by risk elements, the Central Bank will review both its forecasts and the stance of monetary policy towards the future.

Distinguished Guests,

In the final part of my speech, I would like to touch on the risks in question.

Uncertainties about the course of oil prices are the leading risk element with respect to the achievement of the inflation target in the coming period. In the forecasts produced in the previous Inflation Report, oil prices were assumed unchanged. However, these prices persisted to rise throughout this period and reached high levels in recent times. The unfavorable impact of oil prices on annual inflation became one of the factors that slowed down the decline in inflation expectations in the first quarter of 2006. If this tendency persists in the coming months, the impact of oil prices on the 2006 end-year inflation will start to be felt. The effect of oil price increases has not yet gone beyond the relative price changes and has not led to pricing change in the sectors that do not utilize petroleum products as direct input. In other words, the secondary effects remained at a limited level. Nevertheless, expectations have adopted a position that requires more careful monitoring compared the previous quarter. At this point, it should be underlined once more that the CBRT would provide the necessary response, if the increases in oil prices persist and the secondary effects manifest themselves.

Another factor that leads to a slowdown in the disinflation process is unusual price increases in some items, such as rent, due to the persistence of the supply gap in the housing sector. Services price increases, especially rent-originated price increases in the services sector, are expected to realize significantly above the general inflation tendency throughout 2006. It is considered that this development has resulted mainly from the structural factors specific to the transition period and will continue for a certain period of time. But it is also believed that at this stage it does not require any monetary policy response. It is predicted that this situation will gradually be back to normal with the harmonization of housing supply.

The contribution of the increase in the services group to 2006 inflation is forecasted to be around 2.3-3 points. Accordingly, the goods group inflation should be realized at about 3 percent in order to achieve the 2006 target. However, the acceleration in price increases in the items that is not under the control of the monetary policy, such as fresh fruits and vegetables, oil, basic metal and gold, reduces this possibility. At this point, it is meticulously emphasized that price increases in the said items are to a large extent temporary and that monetary policy will not react strongly as far as the secondary effects remain limited.

Another basic risk relating to the upcoming period is the difficulty in foreseeing the global risk appetite and the course of international liquidity conditions. The improvement in the quality of current account financing and favorable developments in public finance in the recent period are considered to increase the endurance of the economy against likely shocks. However, it is a fact that any shock that may come from the said direction in the current situation carries with it the potential to affect our economy unfavorably. In case of such an event, our aim will be to ensure the consistency of inflation with the medium-term targets. In this context, by diffusing the policy reaction over time, the impact of exogenous shocks will be eased without any harm to price stability.

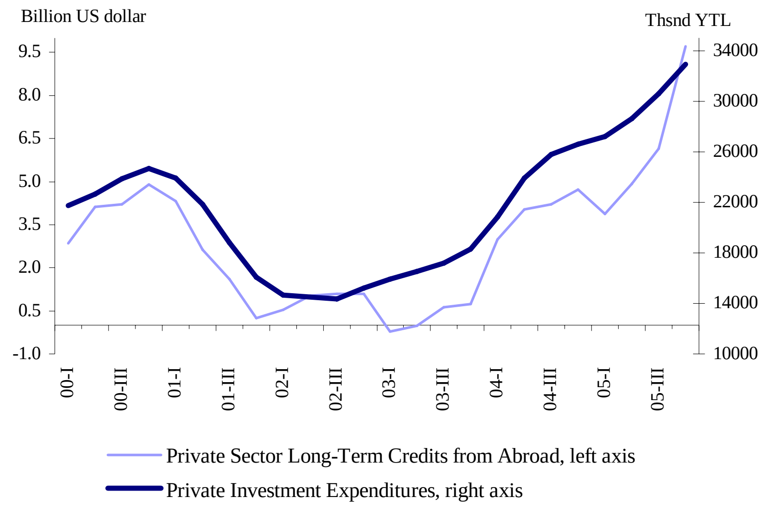
Distinguished Guests,

Price stability is a sine qua non precondition with respect to macroeconomic stability and sustainable growth. Significant steps have been taken in this direction. The CBRT will continue to fulfill its tasks in carrying these achievements forward. It should be kept in mind that the main factor, which is determinant in the sustainability of non-inflationary growth, is the confidence in the permanency of macroeconomic stability. In this context, along with the ongoing determination regarding structural regulations that improve the quality of fiscal discipline, the continuity of reforms that will develop competition and investment environment, thus supporting productivity increases in the long term, is of critical importance.

Thank you.

Annex:

Annex Graph 1. Private Sector Investments and Credit Use (Annualized)



Source: TURKSTAT, CBRT.