

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 15 February 2007

Inflation Developments

1. In January, consumer prices increased by 1% and the annual inflation rate was 9.93% with a rise mainly driven by unprocessed food prices edging up sharply in response to both export- and supply-related factors, while other prices did not reveal a negative outlook.
2. Summary of the previous Monetary Policy Committee (the Committee) meeting indicated that food prices continue to pose a risk on inflation and developments in January's inflation proved this to be true. Unprocessed food prices recorded a historically high increase by 8.82% in January with an annual price increase above 20% driven particularly by greenhouse food prices on which the effects of increasing export facilities were also felt. Although in February a downward movement in the annual unprocessed food price inflation is likely, risks still remain a major concern.
3. The downward trend in the annual rate of increase of goods prices excluding unprocessed food and energy continued as the new Turkish Lira strengthened and domestic demand slowed down. The annual inflation in this sub-group declined to 5.73%, reverting back to the figures in pre-May 2006 period. Likewise, most of the alternative core inflation indicators recorded lower annual figures. Especially the decline in the annual rate of increase in special CPI Aggregate-H (CPI excluding energy, unprocessed food, liquor, tobacco and gold) has become more evident.
4. January inflation developments also pointed to the fact that the expected slowdown in services prices has not occurred yet. The annual rate of increase in transportation services prices decelerated in line with the developments in oil prices, whereas elevating prices of rents and restaurants-hotels continued to keep services inflation at high levels.
5. Despite the rising food price inflation (under CPI), the annual inflation in agriculture prices (under PPI) continued to decline, which can be explained by the fact that most unprocessed foods pushing consumer prices up by sharp rises in January were, in the same month, not included in PPI.

6. In sum the rise in inflation in January did not change the medium term inflation outlook as it can be attributed to the developments in unprocessed food prices. The moderation of energy and other commodity prices along with the disappearance of the base effect of exchange rate pass-through may lead to a substantial decline in the annual inflation rate, starting from the second quarter of 2007. Annual inflation may exhibit a downward movement in February owing to a possible correction in unprocessed food prices and may display an upward movement in March in response to possible administered price hikes. Yet, the disinflation trend will become more discernible starting from the second quarter.

Factors Affecting Inflation

7. The Committee evaluates the recent data as broadly consistent with the outlook presented in the Inflation Report:
8. The slowdown in private consumer demand continues. Consumer credits, following a rapid expansion until mid 2006, slowed down significantly and, notwithstanding a temporary rise in December, resumed its slow growth trend in January. The same course of movement applied to monetary indicators.
9. Despite a slight recovery in the demand for durable goods during the last quarter of 2006, seasonally adjusted monthly automobile sales fell in January, while sales of white goods did not display a noticeable change. Consumer Confidence Index (compiled jointly by Central Bank and TURKSTAT), and the CNBC-e Consumer Confidence Index did not show any significant changes, in January in seasonally adjusted terms.
10. Foreign demand remains relatively strong. In the course of the fourth quarter of 2006, the annual rate of increase of real exports prevailed over that of real imports. In this respect, net export demand is expected to continue its positive contribution to the GDP growth in the last quarter of 2006 as well. Besides, the ongoing high rate of export growth in January and February, as suggested by the Turkish Exporters' Assembly figures, indicates that foreign demand will continue to have a positive impact on growth.
11. Industrial production, consistent with the outlook introduced in the Inflation Report, displayed a slight recovery during the last quarter of 2006. Seasonally adjusted industrial production decreased in December. This development, however, is regarded as temporary when other economic indicators are also taken into account. Business Tendency Survey (BTS) indicators such as the amount of new orders received from domestic and international markets and the volume of sold items for the next three months, and the expected growth of production volume for the next three months do not point to any contraction in economic activity.

12. Machinery-and-equipment investments displayed a partial recovery in the fourth quarter of 2006 compared to the third quarter, which, however, remained subdued considering the previous years. Production and imports in December and sales of commercial vehicles in January did not point to a significant recovery in machinery-and-equipment investments. However, the increase in investment spending tendency- another BTS indicator - in December signals a positive outlook for medium-term investments. On the other hand, the ongoing rise in the non-metallic minerals production in December indicated that the robust activity in construction sector continues.
13. To sum up, the Committee judges that aggregate demand conditions continue to support disinflation. Economic activity is projected to recover gradually in the upcoming period, while growth figures might be relatively low in the second quarter of 2007, largely driven by base effects.
14. In addition, the Committee members noted that the business days between October and January were quite variable – due to shifting holidays - compared to the same period of the previous year, which needs to be taken into account when making a solid assessment for economic activity. In this context, economic data of the upcoming period will be closely monitored.
15. Recent developments indicate that productivity has continued to increase in manufacturing industry in the fourth quarter of 2006. Moreover, the high non-farm unemployment rate is expected to contain the upward pressures in unit labor costs. However, with inflation evidently above mid-term targets, developments in public incomes policy still play a crucial role in the disinflation process.
16. Besides the contributions of aggregate demand and cost factors to the disinflation process, the partial improvement in mid-term inflation expectations was maintained. Although January inflation developments led to a slight rise in the end-year inflation expectations, medium-term expectations continued to improve as of the first half of January.

Monetary Policy and Risks

17. Recently, albeit the unchanged CBT policy interest rates, the returns on government securities displayed a significant decline, particularly on the back of the change in risk perception and favorable international liquidity conditions. The decline in the interest rates of bank loans, on the other hand, remained limited. The current high level of the bank loan rates continue to restrain credit demand. However, bank loans - especially the consumer credits - may re-boost in case the downward trend of credit interest rates gains momentum.
18. Inflation is expected to maintain its downward course in the upcoming period, converging to the targets in the medium run. Yet, several risks remain.

- 19.** The main risk to the mid-term inflation outlook is the possibility of higher-than-expected downward persistence in inflation, manifested lately by the inertia in inflation expectations and services inflation. Although inflation expectations after worsening during the post-financial turbulence period in mid-2006 have recently gained a positive outlook, medium-term expectations are still above the targets. Rigidity in services inflation continued in January. The slowdown in the overall economic activity is expected to contain the services inflation after a while. However, given the backward-looking price setting behavior, the sensitivity of services prices to wage hikes and structural factors, the possibility of sustained high services inflation remains as a risk. Materialization of such a risk would require maintaining the tight policy stance.
- 20.** Another risk to the inflation outlook is the uncertainty concerning the lagged effects of monetary policy on aggregate demand. The impact of monetary tightening exercised since June 2006 on private demand has been noticeable recently. However, the size of economic slowdown and its effect on inflation still remain uncertain. Moreover, the ongoing uncertainties related to government spending constitute an upside risk to aggregate demand and inflation.
- 21.** Waning risk appetite or a possible fluctuation in liquidity conditions in global markets continue to pose a risk against the inflation outlook. Recently, the perception on the US economy that risks between inflation and growth will remain on balance helped alleviate the uncertainties in question. On the other hand, a higher-than-expected growth rate in Japan suggested further monetary tightening. Consequently, uncertainties related to global liquidity conditions, notwithstanding a periodical fallback, continued to exist. The Committee will react appropriately by revising the policy rates in case sudden changes in global liquidity conditions pose permanent challenges to inflation outlook.
- 22.** Developments related to international commodity prices have recently contributed to the inflation outlook. Metal prices continue to decline. Both the balanced growth of global economy and the current level of oil stock foster the expectation that crude oil prices will not display sharp rises in the upcoming period. However, it should be noted that projections for commodity prices involve substantial uncertainty and therefore they need to be assessed as a risk factor under current circumstances.
- 23.** In light of these developments, the Committee decided to keep the policy rates on hold. The Committee has assessed that meeting the medium term inflation targets requires the maintenance of the cautious policy stance. The gap between medium-term inflation expectations and targets, the risks to services prices inflation and the uncertainties in global economy necessitate keeping a tight policy stance.
- 24.** The Committee closely monitors the lagged effects of the monetary tightening since June 2006. Moreover, the potential impact of the progress in the structural

reform agenda and developments in incomes policy as well as public sector non-interest expenditures on inflation and inflation expectations are carefully evaluated. The Central Bank will not hesitate to tighten monetary policy in case of any new developments that would adversely affect the medium-term inflation outlook.

- 25.** The continuation of the European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program remain of critical concern. Developments in structural reforms that would enhance the quality of fiscal discipline in the medium and long run are closely followed both in terms of macroeconomic stability and price stability. Continued determination in implementing the decisive steps taken in these areas in recent years will strengthen the resilience of the economy against possible changes in the global conjuncture.