

SUMMARY OF THE MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 23 February 2006

Inflation Developments

Price increments in tobacco prices, a rise in the transportation and housing group indices due to the developments in energy prices and price increases in the food group due to seasonal effects were the factors that had an adverse effect on inflation in January. Meanwhile, the seasonal decline in clothing prices continued. As a result, the CPI developments being in line with expectations, CPI increased by 0.75 percentage points compared to the previous month. Since the rise in question is higher compared to January 2005, annual inflation increased to reach 7.93 compared to the previous month. As this had already been foreseen by the Central Bank, it was asserted that January inflation figures did not necessitate a significant change in the stance towards the medium-term perspective of monetary policy.

As the VAT cuts on food, health and education sectors made in early 2005 had curbed price increases, price increments in the mentioned groups might be higher in February compared to the same period last year. In other words, a slight increase in inflation in February would not be a surprise.

In January, the outlook of the special CPI aggregates has been positive. Even if an upward trend was observed in the special CPI aggregates in the previous month, generally a downward trend has prevailed in the last eight months and this points to the fact that the downward trend in inflation continues. Hence, inflation expectations continued to improve in the first two months of the year as well. By the second half of February 2006, the expected inflation over the next 12 months is 5.45 percent, which is very close to the path that is consistent with the medium-term target.

Producer prices maintained the favorable course. Manufacturing industry prices, when calculated by excluding petroleum and tobacco products, inched up by a mere 0.21 percent in January and this development is perceived as being positive.

Services prices continue to be a risk factor with respect to attaining the inflation target for 2006. Moreover, as the share of services groups in the consumer price index has been increased while updating the consumer price index for 2006, the mentioned risks have further increased. It is observed that the short of supply in the housing sector in the last few years exerts an extra seasonal pressure on inflation through items related to housing prices. The rapid rises in the prices of the sub-groups susceptible to housing prices (rents, restaurants-hotels, consumer durables) observed recently verify this idea. Meanwhile, even if the rate of increase in rents, which decreased to 1.31 percent in January 2006 from 1.90 percent in January 2005, can be accepted as a favorable development, it is yet too early to suggest that this downward movement will become a trend.

Short-term forecasts made in the light of these evaluations indicate that annual inflation will slightly increase in the first quarter of 2006, but start declining again from the second quarter onwards. What is important for monetary policy is the consistency between the

medium-term inflation trend and the targets. Therefore, evaluating elements such as supply and demand developments, productivity and costs is very important.

Factors Affecting Inflation

The sales figures pertaining to the last quarter of 2005 and developments in consumption indices and consumer tendency surveys contain signals that consumption demand, especially the demand for consumer durables, is stable. Although a slow-down was observed in demand and production indicators in January, this slow-down is considered to stem from the decline in the number of working days caused by the long religious holiday. Nevertheless, quarterly trends of the indicators in the Business Tendency Survey, which include production, domestic market sales and orders and volume of current work, are observed to maintain their favorable course. Furthermore, according to the Manufacturing Industry Tendency Survey data, proportion of the firms, which cited the lack of demand in the domestic market as one of the reasons that impede their full capacity, continued to decline.

The rapid growth trend of investments continued in the last period. According to seasonally adjusted data, increases in the production of machinery-equipment, office machinery and electrical machinery and appliances sectors continued in the last quarter of 2005. In the same period, the data pertaining to domestic sales of commercial vehicles and imports of capital goods also point to the revival in investments. Meanwhile, the distortion observed in the data pertaining to economic activity in January, was reflected on the investment tendency for the next 12-month data in the Business Tendency Survey. However, as the said indicator is still at a high level compared to the achieved level, the investment tendency is deemed to maintain a strong course. As a result of the macroeconomic stability that increased in recent years, long-term interest rates continued to decline gradually and the New Turkish lira retained its strong position. These two factors underpin the revival in investments. These developments ensure the continuation of the increases in *partial* productivity, as well. There is no doubt that what is important for the sustainability of the increases in productivity is the increase in *total factor* productivity. In this respect, the continuation of structural regulations such as the enhancement of competitiveness and amelioration of the investment environment are of great importance.

Industrial production maintains its stable trend. The Real Sector Confidence Index maintained its high level despite its downward movement in January. Meanwhile, the capacity utilization rates being at relatively lower levels compared to the previous year, limits the effects of the revival in the economy on prices. Considering that the increase in production capacity continued throughout 2005, a similar outlook is also foreseen in the upcoming period.

Another significant point related to the developments in January is the annual decline in exports. However, when excluded from the calendar effects such as seasonality and working days, it is observed that exports increased annually. Furthermore, the continuation of the positive course of the expectations that are mentioned in the Business Tendency Survey for the volume of the goods to be sold to foreign markets and the amount of new orders coming from the export market in the upcoming quarter, and the leading indicators announced for February, indicate that the increase in foreign demand will continue, albeit with a slow-down compared to previous years.

Although consumer loans maintain their high levels, their annual rates of increase, excluding housing credits, displayed a stable trend in the last period. This is considered as an indicator of the stability of the increase in domestic demand. There is no doubt that the increases in housing credits, which stemmed from structural factors, might continue in the upcoming years. Moreover, the rapid declines observed in credit interest rates in the past year,

are expected to continue to underpin both consumer and corporate credits. The results of the Banks Loans Tendency Survey for the last quarter of 2005 indicate that the increase in the demand for consumer credits and especially for housing credits will continue. In this context, rapid credit expansion is considered as a development that should be monitored closely in terms of both price and financial stability.

To sum up, the evaluations regarding supply and demand conditions, point to the fact that the stagnation observed in January stemmed from the seasonal factors and that the increase in total demand maintains its stable course. The continuance of productivity increases in line with the investment-based growth restricts cost pressures. Meanwhile, it is anticipated that the support of supply and demand conditions to the downward trend in inflation will be limited in the upcoming period compared to previous years.

Developments in crude oil prices stood as the leading factor in terms of production costs. In recent months, continuation of the unforeseen volatility in oil prices confirms that oil prices remain as a significant risk factor in terms of the achievability of the inflation target for 2006. Moreover, the fact that the International Metal Prices Index registered high increases on an annual basis constitutes another risk factor. Despite of all these unfavorable developments in international raw material prices, the strong position of the New Turkish lira helped restrain the increases in input costs in the recent period.

The risks for the inflation outlook arising from likely fluctuations in international liquidity conditions and global risk appetite are always present. Historically low long-term interest rates in developed countries in recent years led to the flow of international funds particularly to developing countries that made significant progress towards stability, such as Turkey. In case of a reversal in these trends, fluctuations may occur in the financial markets. Although recently the stance of both the European Central Bank and the Federal Reserve provide some signals for the continuation of this trend for quite a while, it is a fact that global trends may change very quickly. The financing structure of the current account deficit has tended to grow stronger recently, which means that the resilience to fluctuations in international liquidity conditions started to increase. Nevertheless, sustaining the structural adjustments in a determined manner and the continuance of implementations that would encourage direct capital inflow are still critical in terms of medium and long-term perspective.

Monetary Policy

In the light of the developments summarized above, the Monetary Policy Committee has concluded that, although there seem to be favorable developments in some cost factors, the data announced recently on inflation and economic activity do not significantly change the outlook elaborated in the Inflation Report. The forecasts indicate that the disinflation process, coming to a halt in the first quarter of 2006, will resume in the second quarter. Despite this downward trend, in light of current data, end-year inflation is more likely to be above the point target of 5 percent rather than below. The cautious approach of monetary policy should be maintained due to the continuation of price rigidities in the service sector, the reduction of the support of supply and demand conditions to disinflation, and the continued risks related to the costs of raw materials. On the other hand, the decrease in the risk premium has been noted and is being monitored with a view to assessing whether it is going to be permanent or temporary.

As a result of these evaluations, Monetary Policy Committee decided to keep short-term interest rates (policy rates) applied at the CBRT Interbank Money Market and the Istanbul Stock Exchange Repo-Reverse Repo Market unchanged at the meeting dated 23 February 2006.

In the light of currently available information, policy rates are less likely to increase, rather than remain stable or decrease in the medium-term. In the near-term, however, the likelihood of policy rates to remain stable seems to have been lessened somewhat since the last meeting. This policy perspective will ensure that inflation is in line with the target path around mid-2007. On the other hand, it should be emphasized that any new data and information associated with the inflation outlook will compel the Monetary Policy Committee to potentially revise its stance about the future.