

No: 2006-15

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## SUMMARY OF THE MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 23 March 2006

### *Inflation Developments*

In February, the CPI index increased by 0.22 percent compared to the previous month and 8.15 percent compared to the same period of the previous year. Hence, inflation displayed a limited increase. Since this was an expected development as described in the Inflation Report, inflation figures in February did not necessitate a major change in the medium-term perspective of monetary policy.

In February, the increase in food prices was the main factor that affected inflation negatively. The main determinant of these price increases, which registered an increase above expectations, can be attributed to the prices of fresh vegetables, which increased significantly due to adverse weather conditions. The 0.58 percentage points of consumer prices, which increased by 0.97 percent in the first two months of the year, was derived from fresh vegetable prices. This development is expected to be temporary. It is also anticipated that the negative impact of the increase in food prices on inflation will weaken in March. Meanwhile, clothing prices continued to decline in February due to seasonal impacts. The fact that winter sale discounts are higher in this group compared to the previous year shows that demand and competition conditions continue to support the decline in inflation. Clothing prices are expected to have a positive impact on consumer prices in March owing to the VAT cuts made in the textile, ready-to-wear and leather sectors from 18 percent to 8 percent.

In February, the developments in the Special CPI Aggregates displayed a positive outlook. Especially the special aggregates E, F and G, which exclude the alcoholic beverages, tobacco products and energy items, maintained a downward trend in the last three quarters and increases in the said indices remained below 7 percent. These developments indicate that the downward trend of inflation continues. Although current inflation is above 8 percent, expectations regarding 2007 indicate lower levels and support the downward trend of inflation.

Producer prices maintained their favorable course. Meanwhile, the increase made in prices of natural gas used in industry has had a negative impact on production costs. The annual increase observed in the manufacturing industry price index, which is calculated by excluding petroleum and tobacco products, maintained its historically low level.

The prices of services continue to be an important risk factor for the attainability of the inflation target set for 2006. Services items increased the said risk, as their share in the CPI was increased by the updates in 2006. Meanwhile, it should be noted that the annual rates of increase in services items that are susceptible to oil

prices have displayed a downward trend. There is no doubt that the course of the rates of increase in the said sub-items will depend on the course of crude oil prices in the upcoming period.

In light of these evaluations, it is foreseen that inflation will start to register a downward trend as of the upcoming month.

### ***Factors Affecting Inflation***

In previous Monetary Policy Committee Discussions, the deterioration trend in domestic demand and production indicators were mainly attributed to the very long religious holiday. Meanwhile, the unfavorable trend in industrial production exceeding seasonal factors is believed to have stemmed from natural gas cuts in the month in question. Actually, the favorable trend in production, volume of orders from the domestic market, volume of goods sold in the domestic market and volume of work in progress over the next three months signals that the slowdown in demand and production is not permanent. Moreover, according to the Manufacturing Industry Tendency Survey, the decline in the number of participants who stated that the reason behind working below capacity was the lack of demand in the market. The Real Sector Confidence Index, which is an important indicator with respect to industrial production, also maintained its stable trend in February. To sum up, data pertaining to domestic sales of automobiles, vehicle loans, consumption indices and consumption goods imports indicate that the stable course in demand and production indicators continues.

Although the stable trend in investment continues, recent developments in domestic sales of commercial vehicles and developments in sectors producing machinery-equipment, office machinery, electrical machinery and electrical appliances indicate that the rapid rise in investment expenditures might slow down in the upcoming period. However, due to the reasons explained above, it should be borne in mind that the developments in January and February might be temporary. Actually, despite the decline in production, the upward trend in imports of capital goods shows that investment expenditures still continue. However, data to be released in the coming months will provide a clearer view.

Besides the data pertaining to investments in machinery-equipment, recent developments in sectors providing intermediate input for the construction sector points to the fact that the increased activity observed in the construction sector at the beginning of 2005 slowed down relatively as of the second half of 2005. However, when the level of production of non-metallic minerals, according to seasonally adjusted data, and the strong demand for houses are taken into account, it is projected that the rise in production in the construction sector will continue. The sustained rapid rise in housing loans also supports this trend. When the data pertaining to housing permits in the third quarter of 2005 are analyzed, it is observed that the rise in housing construction continues. To summarize, even if no upward movement is observed in the said data, indicators pertaining to machinery-equipment and construction sectors provide information that the stable rise in investment demand would continue, at least in the short-run.

One significant point regarding total demand developments is the fact that exports once again started to increase in March. The sustained upward trend in

expectations for the volume of goods to be exported in the next three months and new orders received from the exports market according to the Business Tendency Survey, coupled with the leading indicators announced, signal that the rise in foreign demand will continue even if at a slower pace. Meanwhile, it is projected that the upward trend in imports would also continue and the contribution of net foreign demand to domestic added value would remain limited in the near future.

Although consumer loans maintain their high levels, the annual rates of increase, excluding housing credits, displayed a stable trend in the last period. This is considered to be 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 subsequent years. Moreover, the decline observed in the public borrowing requirement in recent years is expected to underpin both the consumer and corporate credit supply. Rapid credit expansion is taken 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 at the start of the year was temporary and that the increase in total demand maintains its stable course. Although employment, excluding the agricultural sector, has rapidly increased in a stable manner since the second quarter of 2004, the continuance of productivity increases in line with the investment-based growth and structural reform process restricts cost pressures. However, it is expected that the support of supply and demand conditions in the disinflation process 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, the 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 in 2006. Moreover, the fact that the International Metal Prices Index registered high increases on an annual basis constitutes another risk factor.

The risks to the inflation outlook arising from likely fluctuations in international liquidity conditions and global risk appetite are always present. 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 has started to increase. Nevertheless, maintaining structural adjustments in a determined manner and avoiding implementations that would increase perceptions of uncertainty are still critical under current conditions.

### ***Monetary Policy***

In the light of the developments summarized above, the Monetary Policy Committee has concluded that recent developments, while supporting short-term inflation forecasts, do not significantly change the medium-term outlook outlined in the Inflation Report. It is expected that the cut in Value Added Tax rates in the textile, ready-wear and leather sectors, the ongoing productivity increases in the manufacturing industry and the fact that the secondary effects of oil price increases continue to remain limited will favorably affect inflation in the short-term. In light of these developments, it is estimated that the downward trend in annual inflation will

resume starting in March, and end-year inflation will come closer to the point target of 5 percent. However, the cautious approach of monetary policy should be maintained in view of a likely increase in perceptions of uncertainty over monetary policy, the continuation of price rigidities in the service sector, the reduction of the contribution of demand conditions to disinflation, and the continued high volatility in costs of raw materials. Meanwhile, developments in international liquidity conditions are being closely monitored.

In consideration of information currently available, 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 remaining stable seems to have been reduced 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 regarding the future.