

SUMMARY OF MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 24 August 2006

Inflation Developments

1. While the Consumer Prices Index (CPI) increased by 0.85 percent in July, annual inflation reached 11.69 percent. The lagged effects of the fluctuations in exchange rates in May and June on prices, the high increases in food prices beyond the seasonal trend and the continuation of the unfavorable course of energy prices stood as the main determinants of high inflation in July. While the increases in the prices of food and non-alcoholic beverages group made up 0.39 percentage points of CPI inflation in July, increases in the energy prices accounted for 0.30 percentage points of monthly inflation. In previous reports and announcements it had been stated that the effects of exchange rates on inflation would be felt strongly. In this context, the rise in annual inflation in July is not considered as a surprise by the Monetary Policy Committee (the Committee).
2. In July, rapid increases in good prices continued. The rise in prices of the goods stemmed mainly from the high increases in unprocessed food prices since the last quarter of 2005, which results especially from the adverse weather conditions. Besides, high increases in international oil prices and other commodity prices as well as exchange rate developments became influential in the high course of inflation in the goods group.
3. Price increases in the services group lost pace partially compared to the previous year. However, it is notable that high annual increases in prices of rent, hotel-accommodation and transportation services continued. Considering the fact that rent contracts are generally indexed to past inflation, no significant deceleration is expected in rent increases in the short run. It is estimated that such a slowdown process will be observed with lag in the medium term. Meanwhile, prices of transportation services follow a course parallel to that of oil prices.
4. In July, all Special CPI Aggregates registered high increases. Annual inflation of the CPI excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold (SCA D*), which is calculated by excluding temporary factors in order to measure the general inflation trend,

continued to rise mainly due to the lagged effects of exchange rate movements on durable goods.

5. It is observed that the recent appreciation trend of the New Turkish lira (YTL) led to a significant slowdown in the rate of increase in prices of durable goods in August. Moreover, it is expected that certain groups such as fuel oil and gold, which are directly affected by exchange rates, will push down the consumer prices index in August. As a result of these developments and also in line with the disappearance of the impact of price increases in tobacco products on annual inflation, which was experienced in the same period of last year, annual inflation may decline in August.

Factors Affecting Inflation

6. Recently available data have confirmed our earlier conjecture that economic activity would slow down, albeit not as significantly, in the second half of 2006 due to sluggish domestic demand. In the recent period, increases in relative prices of goods with a high imported component and the rise in credit interest rates are affecting demand for durable goods unfavorably. In July, consumer confidence indices continued to fall in line with the decline in the tendency of spending on houses, automobiles and other durable goods. The downward trend in credits continued in August as well. Liquidity shortages in the market, rises in interest rates and the decline in banks' appetites to extend credits will continue to restrain the increase in credits. Meanwhile, indicators related to the volume of sales in the domestic goods market and the expectations regarding the new orders coming from the domestic market for the next three months, collected as part of the Business Tendency Survey (BTS), maintained the upward trend in July, which was first experienced in June following the rapid decline observed in May. This development encourages the belief that the unfavorable effects of fluctuations in May and June on the general consumption tendency may be temporary.
7. No significant deterioration is observed in the indicators related to the investment demand. Imports of capital goods decreased in June due to foreign exchange rate movements. Nevertheless, production volume in the machinery-equipment, electrical machinery and office equipment sectors increased in the same period. Moreover, one of the BTS indicators, the investment tendency over the next 12 month-period increased in July and August following the slump in June. These developments support our projections that the unfavorable impact of fluctuations in May on investment would be limited. The sustained high production level in the non-metallic minerals sector, which provides raw materials to the construction sector, point to the fact that despite the slowdown in housing

loans, the strong investment tendency in the construction sector continues thanks to the already started projects.

8. The rapid increase in exports fuelled by the sustained vigorous economic activity in Europe positively affects the performance of the manufacturing industry. It is forecasted that the manufacturing industry production would grow at a high pace in July just as it did in June. It is estimated that annual growth in industrial production will slightly decrease as of August.
9. The continued rise in relative labor productivity in the manufacturing industry keeps restricting the unit labor costs. There is no significant decline in the investment tendency yet, and this can be considered as a favorable development with respect to the course of the productivity in the medium run.
10. To sum up, factors such as the continuation of the rise in investor confidence in July; the continued rising tendency in consumption items other than motor vehicles and housing; the improved expectations for domestic sales and orders over the next three months; and the strong foreign demand all indicate that the slowdown in total demand might be limited.

Risks and Monetary Policy

11. The effects of the measures taken in June on demand-pull inflation will start to take effect towards the end of the year and will become more apparent by the first quarter of 2007. Since the impact of monetary policy decisions on inflation manifests itself after a certain period of time, the Central Bank needs to act with a medium-term perspective. However, the economic units' tendency to behave in a short-term perspective due to the persistence of their past habits appears as a risk factor that could undermine the effectiveness of policy measures. It has been observed on several occasions in the past that ascribing undue implications on a single month's inflation figure without deep analyzes of the outlook of factors affecting inflation and the developments in the sub-items would increase fluctuations in the financial markets. It should be underlined once more that, rather than short-term developments in inflation, the trends observed throughout an 18-month period perspective are important for monetary policy decisions.
12. In August, the deterioration in medium-term inflation expectations ceased and moreover a slight improvement was experienced. Generally, it can be claimed that the survey participants expect a gradual decline in inflation in the next two years. However, medium-term inflation expectations are significantly above the targets and this emerges as a risk factor in setting wages and prices. The Committee will keep a close eye on the expectations in the upcoming period and maintain its cautious stance until medium-term expectations of the economic units converge to the targets. It should be

borne in mind that the continuity of fiscal discipline and structural reforms is as important as monetary policy in terms of keeping the expectations under control.

- 13.** The Committee emphasizes that, in terms of attaining the 4-percent end-2007 target, it is significantly crucial that the incomes policy must be pursued consistently with the program targets. Moreover, strict adherence to budget limits without resorting to adjustments in public prices and taxes are critical for attaining medium-term targets.
- 14.** There are still uncertainties on the contribution of imported cost factors to the disinflation process in the upcoming period. The volatile course of commodity prices at high levels influences the producer prices. Even if the relative slowdown in demand is expected to ease the pass-through effect from producer prices to consumer prices, developments in this area are still being closely monitored.
- 15.** Recently, international liquidity conditions displayed a relatively favorable course. The fact that US growth and inflation figures were realized below the expectations and thus FED suspended interest rate hikes, has increased the perception that the monetary tightening cycle has come to an end, and which in turn, reduced volatility in emerging markets. Owing to these developments, the risk premium indicators for the Turkish economy have improved moderately. Nevertheless, the picture as to the inflation risks in the USA and whether the FED would deem additional tightening necessary or not are not yet clear. Besides, even if the monetary tightening in developed countries comes to an end, it will not necessarily imply that the global uncertainties have disappeared. Recent analyses point out the fact that the risk of slowdown in the US economy should not be disregarded. Under the scenario that this development could happen earlier than expected, it can be anticipated that global economic uncertainties will persist.
- 16.** In line with the assessments above, the Committee perceives that the medium-term inflation outlook has become slightly more favorable compared to the previous month. However, there is still need to remain cautious for inflation because oil and other commodity prices are still increasing and the expectations are not yet in line with the medium-term targets.
- 17.** In the previous Inflation Report, it was stated that a measured monetary tightening might be necessary in the second half of the year in order to be able to achieve the target for 2007. Committee members made the evaluation that it was still early to signal that the additional monetary tightening is over. Accordingly, they reached a consensus that in case of developments that may adversely affect the medium-term inflation outlook;

the Central Bank would not hesitate – as stated in earlier announcements and reports – to opt for further tightening. Within this framework, the Committee concluded that maintaining the cautious stance for a while was essential for converging to the targets at the end of the year 2007. What is meant by “cautious” stance here is a stance where the Central Bank adheres to its tight monetary policy and is responsive to even the slightest negative development in terms of medium-term inflation.

- 18.** Following the decisions made on June 25, the excess YTL liquidity in the market decreased significantly, and hence liquidity conditions tightened. The actual level of excess liquidity mopped up by the Central Bank in the o/n market allows the monetary policy to be conducted more flexibly and effectively in the period between two subsequent Committee meetings. Until the next MPC meeting, short-term interest rates are foreseen to materialize within the 17.50-21.50 band, close to the Central Bank lending rate of 17.50. However, in case of any extraordinary fluctuations in the markets, the short-term interest rates could be allowed to materialize above 17.50, as long as they remain within the 17.50-21.50 band.
- 19.** Along with all these factors, the continuation of reforms that would enhance the competition and investment environment and thus, bolster productivity increases in the long run, is still of vital importance. In this context, the continuation of the European Union accession process, and the uninterrupted implementation of the structural reforms envisaged in the economic program as planned are crucial. The continuation of the determined steps taken in recent years in this context will help the economy to overcome the adverse changes in the international conjuncture with minimum cost.