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SUMMARY OF THE MONETARY POLICY COMMITTEE DISCUSSIONS
Meeting Date: 27 April 2006

Inflation Developments

As foreseen in the Inflation Report published in early 2006, the downward trend in inflation came to a halt in the first quarter of the year. Compared to that of the previous year, cumulative inflation was realized at a higher rate for the first quarter of 2006. However, this development mainly stemmed from the recent high-rated increases recorded in the prices of alcoholic beverages-tobacco, energy and unprocessed food prices. The growth rate of the index derived by excluding these products shows that the inflation tendency is downwards and the increase in the said index in the first quarter of the year is lower, compared to the same period of the previous year. This observation points to the fact that the basic tendency of inflation is still downwards. On the other hand, it is striking that the cut in Value Added Tax (VAT) in March on the textiles, ready-to-wear and leather sectors has not been passed on to the final prices as it should have been. Moreover, the uncertainties surrounding oil prices, as well as the possibility that the high-rated increases in food prices may persist are considered to be risk factors in terms of short-term forecasts.

High price increases in the services sector, – and especially that of rents – continue to be among the factors cutting down the pace of the disinflation process. Generally speaking, the price increase in the services sector is foreseen to have a share of 2.5-3 points in 2006 inflation. In that case, goods group inflation will have to be realized below 3 percent, for the 2006 target not to be exceeded. However, taking into account the recent high increases in food prices and the costs of raw materials, this doesn't seem to be very likely.

In the light of all these assessments, it can be said that the likelihood of the 2006 target being exceeded is higher than the likelihood that it will remain below the target. Still, what is important here is that our forecast for the disinflation process to prevail in the medium-term remains. As also stated in the Inflation Report published in April, under the assumptions that oil prices remain the same and no exogenous shock occurs in the upcoming period, inflation is foreseen to display a downward tendency in the medium-term.

According to the Expectations Survey data, inflation expectations for the next twelve months retain their horizontal course. With a 4.67 percent, annual inflation expectation by the end of the next 24 months– a question asked for the first time – is at a level close to the targets for 2007 and 2008. In other words, economic units anticipate the disinflation process to continue in the medium-term.

Although the annual growth of the manufacturing industry price index has displayed an acceleration trend recently – also due to the increases in oil and basic metal prices –, it is still at relatively low levels.

Factors Affecting Inflation

Seasonally adjusted GDP figures pertaining to the last quarter of 2005 point to the stable course of growth. The sales and production data pertaining to the first quarter of 2006 support this outlook, as well. Real consumer loan utilization rates maintain their high rate of increase. In the same period, seasonally adjusted domestic sales of white goods increased compared to the previous quarter. Although seasonally adjusted domestic sales of automobiles declined compared to the last quarter of 2005, the data pertaining to February and March indicate that the deterioration observed in January was temporary and the demand for automobiles maintains its briskness. Moreover, the strong upward trend of the imports of consumer goods also continued in the first quarter of 2006.

In light of the current indicators, it is observed that the rate of increase of private consumption was relatively stable in the previous period but it still maintained its strong trend. Meanwhile, private consumption expenditures, which constitute the other component of domestic demand, maintain a favorable course. Some of the indicators that support the strong growth trend in investment expenditures include: In the first quarter of the year, seasonally adjusted imports of capital goods increased rapidly compared to the previous quarter. Similarly, the growth of domestic sales of heavy commercial vehicles continued at a rapid pace in the same period. Production and imports data pertaining to the sub-sectors of the manufacturing industry; machinery-equipment, electrical machinery and office machinery sectors; give positive signals for the continuation of investment growth. According to the Business Tendency Survey, despite the decline observed in investment expenditures in the January-March period, they are still at high levels. Meanwhile, there has not been a significant change in the share of those saying “do not plan any investment expenditures”. In the January- February period, the utilization of long-term credits from abroad displayed a higher rate of increase compared to the same period of the previous year. This development points to the continuation of the strong trend of the private sector’s investment demand. The upward trend observed in the main sector providing intermediate input for the construction sector; other non-metal and mineral production; continued in the first two months of the year. The share of housing credits in total consumer loans continues to grow. When the data pertaining to construction permits are analyzed as of the last quarter of 2005, it can be observed that the upward trend of housing construction continues. In addition to housing construction, the increasing number of construction permits pertaining to industrial buildings is a favorable development for the productive capacity-oriented investments.

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 growth of investments 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.

Risks and Monetary Policy

The ongoing rapid increases in oil prices and other raw material prices in the recent period continue to pose risks in terms of inflation dynamics. The effects of oil prices on inflation have constituted one of the main factors that slackened the downward course of inflation expectations in the first quarter of 2006. If the said trend continues in the upcoming period, the unfavorable effect of oil prices on 2006 end-year inflation will become discernible. The effect of increases in oil prices has been confined to relative price changes so far, and has not led to any changes of pricing in the sectors that do not utilize petroleum products as direct input. This fact is reinforced by the continuance of the downward trend in the annual rate of increase in the index excluding exogenous factors such as the prices of alcoholic beverages – tobacco products, energy and unprocessed food. In other words, current available data show that the second order effects are limited. Nevertheless, expectations should be monitored more carefully than the previous quarter. At this point, it should be underlined once more that the Central Bank will give the proper response if the increases in oil and other raw material prices continue and the second order effects become evident.

The difficulty of predicting the course of the global risk appetite and international liquidity conditions stand as another risk factor in terms of the upcoming period. In the recent period, the improvement in the quality of the financing of the current account deficit and favorable developments in public finance are believed to increase the resistance of the economy to likely shocks. However, despite these structural improvements, it is known that any likely shock arising from the global risk appetite and international liquidity conditions has the potential to unfavorably affect our economy to a certain extent. In order to prevent the said effects from threatening price stability, fiscal discipline as well as prudent monetary policy must be maintained. Besides, avoiding any implementation that would spoil the expectations about economic fundamentals is critical for sustaining the resilience of the economy to exogenous shocks.

In the light of the developments summarized above, the Monetary Policy Committee has concluded that recent developments do not significantly change the medium-term outlook outlined in the Inflation Report of January. In the recent period, growth followed a stable course, investments and productivity increases continued and the second order effects of petroleum and other commodity prices remained limited. The main trend of CPI inflation excluding groups such as energy, unprocessed food and alcoholic beverages-tobacco products, points to a downward movement. Annual inflation is anticipated to decrease starting from the second quarter of the year. However, the cautious approach of monetary policy should be maintained in view of 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 oil prices. 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, new information will be carefully monitored. 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.