

SUMMARY OF MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 26 September 2006

Inflation Developments

1. The recent deceleration in the rate of increases in prices of the items such as energy, unprocessed food, alcoholic beverages-tobacco and gold, which had played a significant role in the rise in inflation in the previous year, has affected the annual inflation figures favorably. In August, annual inflation rate declined to 10.26 percent. One of the determinants of this development has been the removal of the impact of the price increases in tobacco products that had been experienced in the same period of the previous year. Moreover, the continuance of the partial correction in unprocessed food prices strengthens the view that the high price increases observed in the food group during the last 12-months mainly originated from supply-oriented factors.
2. The annual rate of increase of the price index that is calculated by excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold continued to increase in August. The lagged effects of exchange rate movements had played an important role in this rising trend. Although the prices of fuel oil, gold and technology-intensive imported products declined in August along with the appreciation of the New Turkish Lira (YTL), the unfavorable lagged effects of the fluctuations experienced in May and June on prices are still observable, albeit at a slower pace for many products. Meanwhile, the increases in prices of the durable goods that accelerated considerably after May slowed down significantly in August, as it had been foreseen in the previous announcement regarding the summary of Monetary Policy Committee (Committee) discussions.
3. The Committee members consider that it would be helpful to prepare the public in advance for likely fluctuations in inflation in the upcoming months. It is expected that the decline in prices of petroleum products and gold will make a favorable contribution to consumer inflation in September. On the other hand, there might be a temporary increase in inflation in October. The studies conducted by the Central Bank indicate that especially the prices of processed food are likely to display high increases in the month of Ramadan. For the current year, it is calculated that the effect of

Ramadan will be quite visible in October inflation. Analyzing the mentioned effect along with other seasonal factors, it is foreseen that inflation is likely to be realized high temporarily in October.

4. In the recent period, annual price increases in the services group declined, albeit in a limited manner. The most significant decline was observed in transportation services that were mostly affected by the developments in oil prices. Annual price increases in the rents and the restaurants and hotels group maintain their high levels by displaying a similar course to that of the previous year. The annual price increases in these groups are expected to lose pace in the upcoming period along with the slow down in domestic demand.

Factors Affecting Inflation

5. The recently released data related to the factors affecting inflation indicate that the partial improvement in the inflation outlook has continued. Leading indicators confirm our earlier conjecture that total demand would slow down, albeit not as significantly. The fact that the industrial production displayed a rapid increase in July, while, the amount of stock of manufactured goods, one of the Business Tendency Survey (BTS) indicators, has risen at the same time indicates that expectations regarding the demand conditions are not very strong. The decline in the capacity utilization in the manufacturing industry in July and August, as well as the ongoing slowdown in consumer credits and the contraction in demand for money further support this interpretation.
6. While the upward trend in interest rates reduces the demand for credits, weakened risk appetite and contraction in excess liquidity in the market limit the credit supply. Currently available data on consumer credits and confidence indices, as well as sales of automobiles and white goods, indicate that there is a decline in demand for commodity groups, which have a high degree of pass-through from the exchange rates to the prices, such as consumer durables and for sectors that are highly susceptible to financing conditions like the housing sector. Meanwhile, the leading indicators related to the consumption do not reveal a significant slowdown in demand for semi-durable and durable goods.
7. While the indicators related to the domestic demand reveal a notable slowdown, foreign demand pursues a relatively strong course. The continuance of the partial rise in productivity and sustained global economic activity underpins the rise in exports. The fact that the rise in exports supports the economic activities turns out to be a factor limiting the slowdown in total demand.

- 8.** The rate of increase in investments that experienced a slowdown due to the changes in financing conditions and the upsurge in the relative prices of investments is expected to maintain this trend in the short run. As a matter of fact, deceleration is noteworthy in the increase in machinery-equipment production, imports of capital goods and domestic sales of heavy commercial vehicles along with the production of the non-metallic minerals sector, providing intermediate input for the construction sector.
- 9.** Despite these developments, no serious deterioration is observed in the medium- term investment tendency. There has not been a significant decline in the next twelve month-investment expenditure tendency, one of the BTS indicators. Given that demand uncertainty is the most important factor restricting investment expenditures, the continuance of the course of the next twelve month-demand expectations, one of the BTS indicators, in favor of those that consider the capacity level inadequate compared to the expected demand over the next twelve months, indicate that firms perceive the recent environment of uncertainty as temporary and that expectations for demand in the medium term are not pessimistic. The confidence in the economy resulting from the sustained budget discipline and strong course of the long-term credit inflows and the direct capital investments are all considered to be the factors that restrain further deterioration in investment tendency.
- 10.** Rapid increase in productivity of the manufacturing industry and the resulting decline observed in unit labor costs, continued in the second quarter of the year as well. As for the third quarter, no significant change is expected in employment in this sector; however the increase in productivity is forecasted to maintain its high level despite the slight decline compared to the second quarter. In this context, productivity increases are expected to continue in the third quarter of the year as well.
- 11.** The increases in relative labor productivity mainly stems from capital deepening parallel to the strong course of investments in recent years. In this framework, the continuation of reforms for the improvement of the investment environment bears critical importance for the increase in productivity and competitiveness, thereby achieving long-term lasting gains in fighting against inflation.
- 12.** Wage increases in the overall economy stand as another significant development in terms of the medium-term tendency of total demand and unit costs. The Committee has evaluated the arrangements in civil servants' wages for the year 2007 in light of the medium-term inflation outlook and reached the conclusion that the impact of this development on

inflation expectations and other wage arrangements should be monitored carefully.

13. Along with this outlook regarding the labor costs, the easing of oil and other commodity prices provides positive signals for the continuation of the disinflation process as well. The possibility that the world economy may decelerate gives the impression that the rapid increases in commodity prices may stagnate. The developments in oil prices are especially significant in terms of restraining the secondary effects of energy costs, which have been increasing for a long time.
14. In conclusion, when the overall supply and demand indicators are evaluated together, it can be claimed that there is an improvement in the medium-term inflation outlook to some extent, owing to both the slowdown in total demand and the easing of real marginal costs.

Risks

15. The improvement in medium-term inflation expectations has continued in September. In general, the belief in the sustainability of the disinflation process persists. However, the fact that medium-term inflation expectations are significantly above the targets emerges as a risk factor in terms of wage and price setting. In particular, the ongoing high course of inflation expectations for the next two years is considered as a factor that should be monitored carefully.
16. International liquidity conditions, which changed due to the flight to quality effect in May and June, and increased risk perception, triggered the monetary tightening process in emerging market economies. Recent analyses indicate that the risk of an unexpectedly rapid slowdown in the US economy in the medium term should not be ignored. In case such a risk materializes, the risk perception will increase in the short term and fluctuations may be observed in the financial markets. However, since the foreign demand will significantly decline in the medium term in such an environment, the monetary tightening process in developing countries may stop or even reverse.

Monetary Policy

17. Within the context of these evaluations, the Committee decided to keep the policy rates at its current level. Despite the slightly more favorable inflation outlook, it is crucial to preserve the prudent stance in the medium term perspective since the medium-term inflation expectations have not yet reached to the levels consistent with the targets and the uncertainties regarding both commodity prices and international liquidity conditions

continue. The Committee believes that maintaining the cautious stance is essential for the inflation rate to converge to the targets at the end of the year 2007. Under such a policy perspective, the decline in inflation is expected to be more apparent in the second quarter of 2007 and the inflation is expected to converge to the targets in the medium-term.

18. In the event of unfavorable developments, which might adversely affect the medium-term inflation outlook, the Central Bank will not hesitate to opt for further tightening. The Committee defines further tightening in two ways:

- a. In case of a development that might cause inflation to display long-lasting deviations from the targets, the MPC might, in line with the general framework of inflation targeting, change the policy rates. Although there was some improvement in the inflation outlook recently, the Committee considers it too early to rule out the possibility of further tightening.
- b. If an unexpected sudden and major fluctuation occurs in the financial markets before the next MPC meeting that does not comply with the economic principles short-term interest rates in the secondary markets could be allowed to materialize above 17.50, within the 17.50-21.50 band.

19. The Central Bank does not have the leverage to ease the uncertainties regarding global imbalances. However, it seems possible to ease the operational uncertainties related to the interest rates resulting from the current liquidity conditions in the market. Within this framework, the Committee considers it beneficial to share with the public the foresight that short-term interest rates will be realized at levels close to the borrowing rates of the Central Bank in the upcoming months. Considering both the evident slowdown in the demand for money and the Treasury's borrowing program, it seems highly possible that the excess liquidity in the markets will continue. Thus, it is predicted that the o/n interest rates in the money markets will stay close to the borrowing rates of the Central Bank. In other words, the Central Bank, in principle, will not adhere to the mechanism outlined in paragraph 18, article (b).

20. The uncertainties related to the global economy will most probably remain on the agenda in the upcoming period as well. It should be kept in mind that every step taken towards permanent macroeconomic stability would help the economy to overcome the adverse changes in the international conjuncture at minimum cost. 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. Moreover, strict adherence to the budget limits without

resorting to adjustments in public prices and taxes is critical for achieving medium-term targets.