

SUMMARY OF MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 21 December 2006

Inflation Developments

1. While the consumer inflation increased by 1.29 percent in November, the annual inflation decreased compared to the previous month. The seasonal increases in unprocessed food and clothing and footwear group prices played an important role in consumer inflation in November. Price increases in these groups comprised about 0.94 percent of consumer inflation of November. Meanwhile, housing group-oriented energy items displayed increases as well. There has been some decline in the prices of consumer durables due to the effects of the deceleration in domestic demand and the stable course of the exchange rates.
2. The Monetary Policy Committee (Committee) noted that uncertainties pertaining to unprocessed food prices continued. The rate of increase in unprocessed food prices displayed a significant deceleration in the last few months. However, the adverse weather conditions coupled with the decrease in agricultural production, especially in grain production, may affect food prices negatively in the upcoming period. Within this framework, food prices continue to be a risk factor for inflation.
3. The annual rise in the special CPI Aggregate-H excluding the prices of energy, unprocessed food products, alcoholic beverages, tobacco products and gold, reached 9.13 percent in November, remaining relatively stable compared to the previous month. As the increases in the prices of clothing group in the new season has terminated, the primary effects of the exchange rates were completed to a great extent as of December. It is projected that the *monthly* increases in H-index would decelerate in the upcoming period compared to the second half of 2006. However, it will take longer for the effects of supply shocks that have been experienced in the previous period on *annual* change to diminish. Accordingly, no significant decrease is expected in inflation that is calculated by the H- index until the second half of 2007.
4. The annual rate of increase in services prices still preserves its course. The house rents item, which continued to increase rapidly in November, constrained the deceleration in services prices inflation. In line with the decrease in domestic demand, annual price inflation in services group is expected to slowdown in the upcoming period. Meanwhile, taking into account the fact that

the pricing behavior in services sector is highly susceptible to wages, it is believed that services prices continue to be a significant risk factor in terms of attaining the medium-term targets.

Factors Affecting Inflation

5. The Committee considers that recent data is broadly consistent with the outlook presented in the October Inflation Report.
6. Indicators pertaining to private sector consumer demand point to a significant slowdown. The decline in expenditures especially on consumer durables and investment goods stands as an important factor in the deceleration of consumer demand. In line with the deceleration in domestic demand, annual GDP growth decreased to 3.4 percent in the third quarter, confirming our earlier projections that demand conditions would support the decline in inflation.
7. The deceleration in consumer demand in the third quarter can be attributed both to the decline in consumer confidence and the fluctuations in the exchange rates. The decline in private consumption demand halted as these effects started to disappear as of the fourth quarter. Seasonally adjusted data suggest that the decline in automobile sales observed in the third quarter stopped in October-November period. The upward trend of sale of white goods continued in this period as well. Consumer credits and consumption indices indicate that the tendency to lose pace stagnated in November. The indicators in the Business Tendency Survey (BTS) related to the volume of sales in the domestic goods market and the expectations regarding the amount of new orders received from the domestic market for the next three months do not point out a slowdown in private consumption demand beyond the third quarter.
8. The foreign demand remains relatively strong. Due to the fact that exports increased faster than imports in real terms in the third quarter of 2006, net exports had a favorable impact on growth. Indicators pertaining to November and December 2006 indicate that the strong course of foreign demand continues. Persistence of increases in partial productivity, continuation of the vigorous economic activity in the EU, and the Euro gaining strength against the US dollar support the increase in exports. Foreign demand is expected to keep its strong position in 2007 as well.
9. The value added of the industrial sector continued to increase in the third quarter of the year with the help of strong foreign demand. Even though the rate of industrial production in October was low due to the effect of the religious holiday in Ramadan, expectations of companies operating in production industry and increase in utilization ratios in November indicate that industrial production will display a strong trend in the fourth quarter as well.
10. The tightening in financing conditions, the increase in the relative prices of investment goods and the anticipation of a deceleration in domestic demand caused the investment demand to slowdown in the second half of the year.

Seasonally adjusted data on the imports of capital goods and sales of commercial vehicles displayed an upward trend recently, thereby indicating a possible recovery in the machinery-equipment investments in the last quarter of the year. The BTS indicators support this outlook by suggesting that there is no obvious deterioration in investment expenditure tendency for the next twelve-month period.

11. Construction permit statistics point out that construction investments will continue to grow. Even though it is remarkable that the production of non-metal minerals – which is one of the leading indicators of construction activities – has decelerated, considering the fact that exports have declined and imports have increased recently in this sector, the strong course of the construction sector is expected to persist.
12. The public sector expenditures continued to increase in the third quarter of 2006 and a similar tendency is anticipated for the last quarter as well. The Committee closely monitors the effects of the adjustments in the incomes policy and the developments in non-interest public sector expenditures on inflation and inflation expectations.
13. In summary, it is predicted that the deceleration in the economy will not reach the level of stagnation and the economic activity will gradually recover. In the last quarter of 2006, the level of annual growth might be low due to the high basis effect in the same period of 2005. However, owing to the relatively strong course of foreign demand and increases in public sector expenditure items, the slowdown in total demand is not expected to be sharp and the annual growth rates are estimated to increase beginning from the second half of 2007.
14. Productivity increases in private manufacturing industry continued in the third quarter of the year. In the last quarter, the manufacturing industry workers index is not expected to display a significant change, while the increase in production is estimated to strengthen slightly. In this framework, it is expected that the increases in productivity will persist in the last quarter of the year, as well and that unit wages in the manufacturing industry will continue to support the disinflation process.
15. The expectations that the main course of inflation will be downward in the upcoming period remained strong in December, as well. The inflation expectations that displayed a scattered outlook in June and July gained a more consistent structure as of December. This development is considered to be an indicator of the diminishing uncertainties regarding inflation. Nonetheless, medium term inflation expectations continue to remain high above the targets.

Monetary Policy and Risks

16. The current level of inflation is well above the medium term targets. It is expected that the tight stance of the monetary policy will continue to restrain the

private consumption demand and pull down inflation gradually. Nevertheless, the ambiguities relating to the impact of the upward trend in non-interest public expenditures on price dynamics together with the persistence of both high expectations and uncertainties regarding services prices create the risk that inflation will display stronger resistance against the disinflation process than expected.

- 17.** The CBRT produces its medium term forecasts under the assumption that supply shocks will vanish in time. However, the current data indicates that neither the risks related to energy prices nor those related to unprocessed food prices disappeared. As long as medium term expectations are not affected unfavorably, the CBRT will not respond to the temporary fluctuations deriving from these two factors that are beyond its control.
- 18.** The likely changes in the global risk appetite and the new fluctuations that might emerge in financial markets accordingly continue to be one of the main risk factors that might deteriorate the inflation outlook. In case such a risk materializes and medium-term expectations are affected unfavorably, the CBRT will not hesitate to tighten monetary policy through effective liquidity management or policy rate revisions.
- 19.** In the light of these developments, the Committee assesses meeting the medium term inflation targets would necessitate the maintenance of the cautious policy stance and decided to keep policy rates unchanged. Factors such as the gap between the medium-term inflation expectations and the targets, the risks related to services price inflation and the uncertainties in the global economy require that the monetary policy maintain its tight stance.
- 20.** The Committee closely monitors the lagged effects of the monetary tightening since June. Moreover, the potential impact of the progress in the structural reform agenda and the developments in the incomes policy as well as the non-interest public sector expenditures on the inflation and the inflation expectations are carefully evaluated. The CBRT will not hesitate to tighten monetary policy in case developments that would have unfavorable effects on medium-term inflation outlook.
- 21.** The continuation of the European Union accession process and the uninterrupted implementation of the structural reforms envisaged in the economic program as planned are still crucial. The developments related to the structural reforms that will enhance the quality of fiscal discipline in the medium and long terms are monitored closely in terms of both macroeconomic and price stabilities. Continued determination in implementing the decisive steps taken in these areas in recent years will help the economy overcome the adverse changes in the international conjuncture at minimum cost.