

SUMMARY OF MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 23 November 2006

Inflation Developments

1. In October, annual inflation in consumer prices decreased compared to the previous month and became 9.98 percent. The partial correction in unprocessed food prices was the main determinant of this improvement in annual inflation. In addition, developments in oil prices contributed to the favorable inflation outlook in October.
2. The annual rise in Special CPI Aggregate excluding the prices of energy, unprocessed food products, alcoholic beverages, tobacco products and gold, which has started to be published as the -H index by TURKSTAT beginning from September, continued to accelerate in October, reaching 1.82 percent, around two-thirds of which originated from the clothing and the apparel prices. The clothing prices, which increased at a higher rate compared to the same period of the previous year, point to the fact that the unfavorable price movements are attributable to the lagged effects of the exchange rate pass-through as well as to the seasonal factors. It is anticipated that the monthly rate of increase of the H index will decelerate starting from December, while the annual rate of increase will continue to be at high levels for a slightly longer period of time.
3. It is calculated that the cumulative exchange rate pass-through impact on annual inflation of the durable goods prices reached 5.5 percentage-points since the volatility in the financial markets in May–June period. It is assessed that the lagged effects of exchange rate pass-through on the prices of the durable goods group are almost complete as of November. However, the impact of the pass-through is expected to be visible on annual inflation for around one year.
4. High rates of increase in prices of the services group continued in October as well. However, it is expected that the moderation in domestic demand may drive the annual inflation in the services group down in the upcoming period. On the other hand, the relatively low level of productivity in the services sector compared to internationally competitive goods together with the strong backward looking component in the pricing behavior of this group constitute a risk factor in terms of achieving the medium-term targets.
5. The effect of Ramadan on unprocessed food products have completely disappeared as of November. Nevertheless, as stated in the “October Price

Developments” report, the weather conditions may have a negative impact on November inflation through unprocessed food prices. However, it is expected that the aforementioned effect will be temporary and will not alter the main inflation outlook.

Factors Affecting Inflation

6. The Monetary Policy Committee (the Committee) considers that recent data is consistent with the outlook presented in the Inflation Report. The indicators point to a significant slowdown in the private domestic demand, especially on interest rate sensitive sectors such as durable goods and housing. In seasonally adjusted terms, automobile sales registered a remarkable decline in the third quarter compared to the previous one. Furthermore, developments in consumer loans and demand for money confirm the deceleration in domestic demand.
7. Foreign trade data point to a deceleration in demand as well since the recently available data reveal the fact that imports of consumer goods have declined both in annual terms and in terms of the seasonally adjusted monthly data, which can mainly be attributed to developments in consumer durables. Imports of consumer durables are declining, whereas the increase in imports of other consumer goods still continues.
8. Meanwhile, according to the Business Tendency Survey (BTS), there is no decline in domestic demand expectations over the next three months in terms of seasonally adjusted data. This indicates that expectations are not pessimistic.
9. Foreign demand continues to be relatively strong. Although some degree of deceleration was observed in the export growth in October due to the impact of Ramadan and the religious feast, leading indicators of November reveal that this is temporary and the strong course of the external demand is preserved. The sustained increase in partial productivity and vigorous economic activity in the European Union continue to support the rise in exports.
10. The high primary budget surpluses have supported the disinflation process to a large extent during the past years. However, considering the current level of inflation, the composition of the primary budget balance in terms of the incomes and expenditures items is as crucial as the primary budget balance itself. Opting for making adjustments in expenditures rather than raising indirect taxes to meet any additional resource requirements that may arise in line with the primary surplus targets will help to fight inflation. Moreover, reflecting the rise in the imported input costs of goods produced by State Economic Enterprises on prices immediately will enhance the predictability and alleviate future risks regarding inflation.

- 11.** In sum, it is considered that the slowdown in total demand will not be as sharp due to both the high level of increases in public expenditure items and the relatively strong course of net foreign demand. As a matter of fact, the recent data on industrial production and capacity utilization rates indicate that the deceleration in overall economic activities is not that severe. Nevertheless, Committee members drew attention to the risk that the slowdown in total demand might be more significant than expected, should exports display a weaker performance than predicted. In this framework, the developments in the foreign demand will be closely monitored along with developments in domestic demand.
- 12.** The tightening in financing conditions, the increase in the relative prices of investment goods and the anticipation of a deceleration in domestic demand caused a loss of pace in investment demand in the second half of the year. Seasonally adjusted data on the imports of capital goods and domestic sales of commercial vehicles display a decline in the third quarter compared to the previous one. However, the BTS results indicate that, there is no obvious deterioration in investment expenditure tendency for the next twelve-month period as of October 2006. In other words, the stable investment tendency is expected to continue in line with the expectation that macroeconomic stability will be permanent in the medium-term.
- 13.** There has been a decline in unemployment rates in the last three months. Given that labor force participation and employment rates follow a relatively low course, it is considered that this decline in unemployment rates does not exert pressure on wages and inflation. On the other hand, deterioration in the expectations of both the households and firms relating to the employment in the near future is indicative of the fact that the conditions in the labor market might support the disinflation process.
- 14.** Inflation expectations continue to improve in November, albeit at a slower pace. The expectation that the inflation will follow a declining trend in the upcoming period remains strong. Nonetheless, the fact that medium term inflation expectations continue to remain considerably above the targets necessitates monetary policy to preserve its cautious stance.
- 15.** Rapid increases in oil prices have come to a halt in recent months, although on the other hand, the high level of oil prices continues to exert pressure on costs. The accumulated past increases in oil prices have started to be effective on natural gas prices. At this point, it should be noted that the Committee took those lagged effects into consideration beforehand, and any likely changes in the electricity prices as well while forming its monetary policy perspective Committee.

Monetary Policy and Risks

- 16.** The Committee evaluates that the impact of tightening monetary policy has already started to manifest itself on economic activity and that it is expected to be observed on inflation in a lagged manner. Nevertheless, given that the impact of the upward trend of non-interest public expenditures on price dynamics is not clear, the inflation expectations continue to follow a high course relative to the targets and the uncertainties relating to the services price inflation still prevail, there emerges the risk of higher-than-expected inflation inertia. Should such a risk materialize, it may be necessary to maintain the current tight stance of monetary policy for a long time in terms of achieving medium term targets.
- 17.** Any 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. If 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.
- 18.** In the light of these developments, the Committee assesses that meeting the medium-term inflation targets would necessitate the maintenance of the cautious policy and decided to keep policy rates unchanged. However, the factors such as the gap between medium-term inflation expectations and the targets, the risks related to the services price inflation and the uncertainties in the global economy require the monetary policy to maintain its tight stance.
- 19.** The Committee closely monitors the lagged effects of the monetary tightening since June. In addition, potential impacts of the recent developments in the incomes policy and the non-interest public sector expenditures are carefully evaluated. The CBRT will not hesitate to tighten monetary policy, in case of any new developments that would have unfavorable effects on medium-term inflation outlook.
- 20.** 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 in terms of the medium and long-term outlook. Continued determination in implementing the decisive steps taken in these areas will help the economy to overcome the adverse changes in the international conjuncture at minimum cost.