

SUMMARY OF MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 19 October 2006

Inflation Developments

- 1.** Annual inflation in consumer prices reached 10.55 percent in September. While high rates of increase in the prices of unprocessed food products continued to affect inflation adversely, oil and gold prices have had a favorable impact on inflation in September. Besides these factors, it is considered that the effect of Ramadan was another determinant factor of September inflation, especially through the prices of processed food products. It is expected that this effect will continue in October price index as well, but food prices might adjust in November.
- 2.** Prices of food group have been playing an important role in the rise in consumer inflation for the last one year-period. When the sub-items of this group are analyzed, it is observed that the rise in the prices of processed food products accelerated recently due to the lagged effects of the rise in exchange rates. On the other hand, the expected normalization in the prices of processed food products is not yet in place. The fact that the prices of fresh fruits, which had decreased by 12.9 percent cumulatively in the first nine months of 2005, increased by 35.2 percent in the same period in 2006 indicates that supply-side shocks are influential in the movements of the prices of unprocessed food products.
- 3.** The effect of exchange rate movements on consumer durables decreased in September. It is observed that such effects have already shown up on prices of electrical and non-electrical appliances and automobiles to a great extent, while the rapid rise in the prices of furniture group continues. It is expected that the price inflation of the furniture group will decelerate in the upcoming period as well, in line with the improvement in cost conditions and the slowdown in domestic demand.
- 4.** High course of increase in the annual prices of services group continued in September as well. In particular, house rents and hotel-accommodation group prices continued to rise rapidly due to the backward indexation behavior. It is predicted that transportation services prices, which are quite susceptible to oil prices, will contribute favorably to the inflation in the upcoming period.

5. 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 "ÖKTG-H index" by TURKSTAT beginning from September, continued to accelerate. As this development had already been foreseen by the Central Bank, it was not perceived as new information that could affect the monetary policy decision-making process. As the share of durable goods in this index is quite high, it is affected considerably by the fluctuations in the exchange rates. Although, it is predicted that, due to the improvements in the cost factors and the deceleration of domestic demand, the monthly increases of the aforementioned indicators will tend to slow down in the upcoming months, the high course of the annual increases is expected to continue for the time being.

Factors Affecting Inflation

6. There is a significant deceleration in the demand for private expenditure groups such as durable goods and housing that are responsive to interest rates. Moreover, developments in credit aggregates confirm the slowdown in the domestic demand. Especially, increase in consumer loans lost pace in the recent months. While housing loans and credit cards show a moderate increase, automobile credits are in a decreasing trend. The increase in the total consumer loans mostly stemmed from the loans, which are extended in low amounts with shorter maturity but higher interest rates compared to the housing and automobile loans.
7. External demand is relatively strong, albeit not as much as expected. The continued increase in partial productivity and the relatively robust world economy continues to support the rise in exports.
8. Public sector incomes policy is another important factor for the medium-term inflation outlook. Increase in the wages of public sector has a crucial role in shaping the inflation expectations. According to the national income statistics announced by the TURKSTAT, almost half of the labor force payments come from the public sector. Thus, wages in the public sector are also important with regard to the demand-push effects. Within this framework, the wages awarded to the civil service servants for 2007 will not be able to support the disinflation process.
9. Due to the persistence of the increase in productivity and the rise in wages remaining limited, the decline in the unit labor costs in the private manufacturing industry continued. Compared to the same period in the previous year, the unit labor costs decreased by 8.1 percent in the second quarter of 2006. However, in case the increase in the real wages of the public sector in the upcoming period becomes a precedent for the private

sector, the decline in the real unit wages of the private manufacturing industry will be lower compared to the previous periods.

10. It is considered that the deceleration in aggregate demand in the second half of the year will be limited due to both the high level of increase in public expenditure items and the relatively strong course of the net foreign demand. Thus, although the industrial production in July and August and the seasonally adjusted data on capacity utilization rates of the July-September period are at lower levels compared to the second quarter of the year, they do not point to a significant slowdown in economic activities. In addition, Committee members evaluated that the past policy measures had not been significantly effective on economic activity yet and that the lagged effects should be monitored closely in the upcoming months.
11. The continuation of the improvement of inflation expectations is considered as a favorable development. Nonetheless, the fact that medium term inflation expectations continue to remain high above the targets necessitates the monetary policy to preserve its cautious stance.
12. Rapid increases in oil prices came to a halt in recent months. As a result of these developments, the price increases in transportation services lost momentum. However, the fact that there will be some lagged effects of the past increases in oil prices on natural gas and electricity prices indicate that energy prices will continue to affect inflation unfavorably in the upcoming period.

Monetary Policy and Risks

13. The medium term inflation target of the Central Bank is set as 4 percent. In order to achieve this target, monetary policy instruments will be used effectively. Nevertheless, there exist important risk factors that might slow down the disinflation process in the upcoming period.
14. Committee members highlighted the fact that the current level of the credit interest rates, which are the most important determinant of domestic demand, is considerably high compared to the first half of 2006 and assessed that this development will continue to constrain the credit demand of individuals and firms in the upcoming period. However, considering the facts that the impact of the upward trend of non-interest public expenditures on the 2007 inflation is not clear and there exist other uncertainties regarding the monetary transmission mechanism, it should be borne in mind that the disinflation process may materialize at a slower pace than anticipated. In case such a risk materializes, in terms of achieving the medium term targets, it might be necessary to maintain the current tight stance of the monetary policy for a long time.

- 15.** The likely changes in global risk appetite and the new fluctuations that might emerge in financial markets continue to be one of the main risk factors that might deteriorate the inflation outlook. The available indicators regarding the US economy point to a gradual slowdown. This has contributed to the improvement in the short-term inflation outlook by limiting the increases in oil prices. On the other hand, it should be taken into account that a rapid slowdown in the US economy more than expected may lead to a temporary deterioration in the risk appetite. In case such a risk materializes and the medium-term expectations are affected unfavorably, the CBRT will not hesitate to tighten monetary policy through effective liquidity management or policy rate revisions.
- 16.** Risks that may arise from high course of medium-term inflation expectations and the persistence of the backward-looking pricing behavior in the services group stand as another factor leading to uncertainties in terms of inflation outlook. The services inflation, which is currently around 12 percent, is anticipated to decrease further in a certain extent next year in line with the slowdown expected in domestic demand. However, the possibility that the stickiness in services inflation may be higher than expected, due to the continuation of backward-looking pricing behavior and other structural factors emerges as a risk element. The fact that incomes policy set for 2007 stipulates high increases in wages augments the risks regarding services prices.
- 17.** As a result, the Committee has decided to keep policy rates unchanged and maintain the current cautious stance. However, the factors such as the continued presence of a gap between the medium-term inflation expectations and the targets, the emergence of new risks related to services prices and the continuation of uncertainties in the global economy necessitate the monetary policy to remain cautious in the medium term.
- 18.** In light of these developments, the Committee perceives that maintaining the cautious stance is necessary for the inflation rate to converge to the 2007 year-end targets. The Committee closely monitors the lagged effects of the monetary tightening that has been carried out since June. In addition, the impact of the incomes policy and the non-interest public sector expenditures on the 2007 inflation are closely monitored as well. The CBRT will not hesitate to tighten monetary policy, in case developments with unfavorable effects on medium-term inflation outlook are observed.
- 19.** 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 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.