

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 16 January 2007

Inflation Developments

1. Inflation continued its recent downward course in December and declined to 9.65 percent at the end of the year. The main determinant of consumer price developments in December is the decline in clothing and footwear prices that is beyond seasonal trends. On the other hand, the annual rate of inflation in unprocessed food prices increased. Meanwhile, owing to the stable course of the New Turkish Lira and the slowdown in demand, the decline in annual inflation of durable goods prices continued in December.
2. The Monetary Policy Committee (The Committee) has noted that uncertainties regarding unprocessed food prices continue. The deceleration in the rate of increase in unprocessed food prices in the last few months came to a halt in December. Persistence of adverse weather conditions coupled with the recent slump in agricultural production, especially in grain production, may have an adverse effect on food prices in the upcoming period. Within this framework, the Committee considers that food prices continue to be a risk factor for inflation.
3. The Committee has also noted that the decline in oil prices affected the inflation outlook favorably. Fuel oil prices decreased by 10.18 percent in the August-November period. However, energy prices related to the housing group increased by 3.19 percent in the last quarter due to the rapid increases in the prices of natural gas and solid fuel items and this caused energy inflation to rise in the last two months of the year. The Committee concludes that the recent favorable developments in oil prices are not yet significant enough to change the medium-term inflation outlook, given that there is still a considerable amount of uncertainty regarding oil prices and lagged effects of the past cumulative price increases.
4. The annual rate of increase of the special CPI Aggregate-H (CPI excluding energy, unprocessed food products, alcoholic beverages, tobacco products and gold) declined to 8.89 percent in December. This development can be attributed to the decline in clothing and footwear prices that is beyond seasonal trends, and by the significant decrease in prices of durable goods. Although it is projected that the monthly rate of changes in the H-index may exhibit some volatility in the upcoming period due to seasonal price movements, the overall trend is expected to be downwards in the medium term.

5. In 2006, the decline in annual inflation of services was quite limited, due to the persistent high inflation in the prices of rents and accommodation services. The possibility of the continuance of this trend in the upcoming period emerges as a risk factor for disinflation.

Factors Affecting Inflation

6. The Committee evaluates the recent data as broadly consistent with the outlook presented in the October Inflation Report.
7. The slowdown in private consumption demand continues. After declining sharply in the third quarter as a result of depreciation of the YTL, increasing credit interest rates, and lower consumer confidence, the demand for durable goods increased moderately in the fourth quarter. Although seasonally adjusted data suggest that automobile sales are stronger than the previous quarter, the annual growth rate still remains negative. The data for the October-November period indicate a modest increase in white goods sales compared to the third quarter. Business Tendency Survey (BTS) indicators also point to a sluggish recovery in private consumption in the last quarter of 2006.
8. Although consumer credit, which had stopped its rapid growth in the third quarter in line with the rise in interest rates, has shown some tendency to recover in the fourth quarter, there is still a significant slowdown in the rate of increase in consumer credit in annual terms. While housing loans grow at a low rate, vehicle loans continue to decline in real terms. These developments are in line with the slowdown in private consumption demand. The recent rise in credit utilization stems mainly from items other than housing and vehicle credits. This suggests that the coincidence of the New Year and the religious feast holidays has caused consumers to use consumer credits and credit cards intensively to meet their increased expenses. In other words, the recent hike in consumer credit does not point to a rebound; it can be largely explained by seasonal factors.
9. External demand remains relatively strong. The net exports made a positive contribution to overall economic activity in the second half of the year. Sustained increases in labor productivity coupled with the robust economic activity in the EU, and the euro's strength against the US dollar support the export growth. The leading indicators pertaining to January suggest that external demand remains strong as of early 2007.
10. Industrial production continued to increase during the last quarter of 2006 with the help of strong external demand. The high annual growth rate in industrial production in November can be explained by the higher number of working days compared to the same month of the previous year, due to the lunar-calendar-based religious holiday. However, the seasonally adjusted figures point to a rise in production as well. The high capacity utilization ratios in

manufacturing industry in December and the benign expectations of companies indicate that the rise in industrial production continued in December as well, pointing that industrial production has kept growing in the last quarter of 2006. Moreover, according to the BTS, the companies' expectations for production volume for the next three months in seasonally adjusted terms also exhibit positive signals for industrial production.

- 11.** The tightening in financial conditions, the increase in the relative prices of investment goods and the expectation of deceleration in domestic demand caused investment demand to slowdown in the second half of the year. The leading indicators pertaining to investment demand point to a rise in investment in the last quarter in seasonally adjusted terms. Sales of commercial vehicles increased in the last quarter compared to the third quarter. Imports of capital goods, as well as production and imports of machinery-equipment, office equipment, and electrical machinery and appliances in the October-November period exceeded those in the third quarter. The statistics on the construction permits and non-metallic minerals sector production that are closely related to construction investments indicate that robust activity in the construction sector continues. Moreover, the BTS indicators do not point to a significant deterioration in investment expenditure tendency over the next twelve-month period as of November, thereby supporting this view.
- 12.** To sum up, although economic activity has shown a tendency to recover in the last quarter of 2006, overall demand conditions continue to support disinflation. Despite the relatively strong course of external demand and increasing public expenditure, total demand slowed down compared to previous periods. The annual growth rate of output is expected to be low in the last quarter of 2006, due to the high base in end 2005. It is projected that the economic activity will continue to recover gradually in the upcoming period.
- 13.** Unit labor costs in the private manufacturing sector continued to decline since productivity increases were higher than the rise in real wages. This, in turn, continued to support the disinflation process in the third quarter of 2006. A similar trend is expected in the last quarter of the year.
- 14.** Recently available data indicate that the rate of decline in agricultural employment started to slow down significantly, while the employment in other sectors continued to rise. However, the fact that the unemployment rate in non-agricultural sectors is still as high as 11.9 percent suggests that the rise in employment has not yet reached a level that would exert pressure on inflation. On the other hand, the recent wage adjustments that are above the inflation target may hinder the disinflation process via its impact on expectations and production costs.
- 15.** Inflation expectations continue to improve. The distribution of inflation expectations that displayed a wide dispersion in June and July gained a more

consolidated structure in recent months. Agents still expect that the disinflation process will continue in the medium term. Nevertheless, medium-term inflation expectations are still significantly above the targets.

Monetary Policy and Risks

- 16.** The Committee assesses that under the current circumstances monetary policy stance in Turkey is non-accommodative. The decline in inflation expectations has continued to tighten the monetary conditions in the last quarter of 2006. In other words, although policy rates remained unchanged, the real rates have continued to increase. Longer-term interest rates such as the interest rates on government securities and consumer loans stayed at higher levels.
- 17.** We expect aggregate demand conditions to support the underlying disinflation process in the next couple of quarters. However, there are some risks regarding the medium-term inflation outlook.
- 18.** The main risk factor for the medium-term inflation outlook can be stated as higher-than-expected inflation inertia, as currently manifested in the inertia in medium-term inflation expectations and services inflation. We expect that slowdown in the aggregate demand will induce a gradual decline in services inflation in the period ahead. However, given the low relative productivity growth in the services sector, backward-looking price setting behavior, and the sensitivity of services prices to wage hikes, the developments in prices of services should continue to be closely monitored. The recent wage hikes have highlighted these risks even more. Given that we plan to bring inflation down from 10 percent to 4 percent in a fairly short period of time, the Committee judges that the possibility of a sustained persistence in high services inflation stands as a major risk for the medium-term outlook. Realization of such a risk could require keeping the tight policy stance for an extended period.
- 19.** Another risk for the inflation outlook is the uncertainty regarding the impact of the monetary policy on aggregate demand. Lags in monetary policy transmission are time variant across countries, and the Turkish economy is no exception. The sizeable slowdown in the third quarter of 2006 was a result of lower confidence due to financial market volatility in May-June period, rather than an outcome of the tightened monetary policy. Although the tightening exercised since June 2006 started to be effective on private demand recently, the extent and the duration of the slowdown in overall economic activity remains to be seen. There are also some uncertainties related to the behavior of government spending, which could represent an upside risk to aggregate demand, and therefore inflation in 2007. In this respect, the MPC has been closely monitoring the macroeconomic impact of the developments in incomes policy as well as public sector non-interest expenditures.

- 20.** Another risk factor that may delay attaining the medium-term targets is the possibility of a sudden change in the global financial market sentiment. Global liquidity is still the major factor in shaping risk appetite and volatility in financial markets. Currently, the concerns over high inflation and thus higher interest rates in the United States seem to have diminished. However, a faster than envisaged slowdown in the world economy or disorderly developments owing to global imbalances still remain as possible scenarios that may lead to another wave of portfolio shock in emerging markets. The Committee will revise the policy rates if these shocks turn out to have lasting effects on the medium-term inflation outlook.
- 21.** There are favorable scenarios regarding the inflation outlook as well as unfavorable ones. Turkey is a net commodity importer. Although a slowdown in the global economic growth or a further easing in commodity prices could have an immediate adverse impact on domestic inflation through its impact on the global risk appetite, it will also lead to a positive terms of trade shock and thus to a more favorable outlook in the medium term.
- 22.** In light of these developments, the Committee decided to keep the policy rates on hold. The Committee has assessed that meeting the medium term inflation targets necessitates the maintenance of the cautious policy stance. The gap between medium-term inflation expectations and the targets, the risks related to services price inflation, and the uncertainties in global economy necessitate keeping the tight policy stance.
- 23.** The Committee closely monitors the lagged effects of the monetary tightening since June 2006. Moreover, the potential impact of the progress in the structural reform agenda and developments in incomes policy as well as public sector non-interest expenditures on inflation and inflation expectations are carefully evaluated. The Central Bank will not hesitate to tighten monetary policy in case of any new developments that would adversely affect the medium-term inflation outlook.
- 24.** The continuation of the European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program are still crucial. Developments related to the structural reforms that would enhance the quality of fiscal discipline in the medium and long run are followed closely from the perspective of both macroeconomic stability and price stability. Continued determination in implementing the decisive steps taken in these areas in recent years will increase the resilience of the economy against possible changes in the global conjuncture.