

## SUMMARY OF THE MONETARY POLICY COMMITTEE DISCUSSIONS

Meeting Date: 23 January 2006

### *Inflation Developments*

In December, significant increases in the prices of tobacco products and other increases in household goods and various goods and services groups adversely affected inflation. On the other hand, fruit and vegetable prices, which had significantly increased in November, decreased in December to a great extent. With 7.72 percent, annual inflation was realized close to the target.

VAT cuts made in food, health and education sectors in the first quarter of 2005 limited price increases. Even if the downward course in the inflation trend continues, the decline in annual inflation may be interrupted in the upcoming months, due to the base effect caused by the VAT cuts and the fact that the price increase on tobacco products in December will also be reflected in the January inflation.

Considering the fact that price increases in tobacco products and oil led to more than 2 points of increase in inflation in 2005, it can be said that the difference between the current trend of inflation and the 2006 target is not significant. Moreover, the decline observed in the growth rates of the special CPI indices in the second half of 2005 confirms that the downward trend in the main course of inflation continues. Although some upward movements were again recorded in the said aggregates in December, it is rather early to decide whether this development will turn into a trend or not. As a matter of fact, inflation expectations also continued to improve in the last quarter of 2005. As of January 2006, the end-year inflation expectation is 5.7 percent. Although inflation declined by 1.6 points throughout 2005, inflation expectations for the next twelve months decreased by 2.9 points. This development shows that the secondary effects of oil prices will be limited, at least in the short-term.

Producer prices maintained their favorable course. Excluding those items directly affected by petroleum products, it is observed that price increases in the manufacturing industry are at very low levels. This low level of increase is believed to be related to productivity increases, the strong position of the New Turkish lira and increased foreign competition.

The rigidity of price increases in the services group continues. In the process of the economic revival and structural transformation, the differentiation in the growth rates of goods and services prices became more evident. The rigidity in services inflation mainly stems from the continuity in the demand for services and the backward-indexation behavior in services pricing. Considering the high productivity increases in tradable goods and the structural transformation process in the economy, it may seem normal that the services group inflation continues to be significantly higher than the goods group price increase. However, the supply gap in the housing sector in recent years and the resulting rapid increases in house prices are observed to exert additional periodical pressure on the prices of the related services items. This assessment draws support from the fact that price increases in the subgroup of rents

within the CPI and in those groups, where rents are significant input costs, are almost at same levels with those in 2004, despite the continued downward trend in inflation. In this respect, it is anticipated that the price increases in the services group will continue to adversely affect inflation in 2006 as well, due to the structural transformation experienced by Turkey and the pricing habits peculiar to a period of high inflation.

Short-term forecasts made in the light of these evaluations indicate that annual inflation will slightly increase in the first quarter of 2006, but decline again starting from the second quarter onwards.

### ***Factors Affecting Inflation***

The data recently released on sales, consumption indices and consumer tendency surveys provide signals for the continuation of the revival in consumption demand, especially the demand for durable goods. Furthermore, according to Turkstat data, there is a significant decline, compared to the previous year, in the number of firms that cited insufficient demand in the domestic market as one of the reasons for operating under full capacity. This indicates that the domestic demand is not sluggish at the current level.

The indicators regarding investment expenditures point out that the rapid growth of investments continues. According to the seasonally adjusted data, increases in production continue in the machinery-equipment, office machinery and electrical machinery and appliances sectors. The data on domestic sales of commercial vehicles and the import of capital goods also indicate that the revival in investments continues. In the Business Tendency Survey, the investment tendency and the expectations for credit interest rates expected in the next 12-month period also support the strong growth tendency of investments. Hence, this situation is considered as a factor that will contribute to the continuation of the increases in productivity despite the high-rated increase in the demand for non-agricultural labor force.

The structural economic reforms should continue for the sustainability of gains in productivity. The efforts made to reduce the role of the public sector in the economy, in terms of both financial burden and also production activity, constitute an important part of this process. The privatization performance attained in 2005 will provide a further lift to productivity in a more competitive environment, as well as contributing to the financing of the current account deficit. The privatizations in energy and communication sectors in 2005 are considerable developments in this respect. In fact, in the scope of structural arrangements, it is observed that the energy sector has displayed rapid increases in productivity and made contributions to industrial production in a stable manner since 2003. Therefore, the continuation of the structural arrangements such as the enhancement of competitiveness and improvement of the investment environment, which would boost the increases in productivity, is of great importance.

Industrial production, which is one of the basic economic indicators for economic activity, continues to increase in a stable manner. The high level of the real sector confidence index indicates that the increase in industrial production will continue, at least in the short term. However, the fact that capacity utilization rates are at lower levels compared to the previous year, limits the effects of the revival in economic activities reflected on prices. Considering the fact that the increases in investments continued throughout 2005, a similar outlook is expected in the upcoming period as well.

Despite a relative stable trend in annual increase rates of consumer credits in the last period, they still maintain their high levels. Declining interests and extending maturities in line with the normalization process of the economy and the deterioration in inflation expectations lead to a reduction in domestic government borrowing and support the credit supply by changing banks' portfolio preferences. The financing program announced by the Treasury for 2006 provides significant signals for the continuation of the said tendency in the upcoming period.

The substantial decline in credit interest rates and the gradual extension of maturities caused by the normalization process of the economy made credit utilization more appealing. Hence, the demand for credit increased substantially. There is no doubt that these developments that led to an increase in both credit supply and credit demand support domestic demand. However, it should be taken into consideration that the impacts of intense credit utilization on expendable incomes and the continuation of fiscal discipline are the factors that stabilize domestic demand. At this point, rapid credit expansion is considered as a development that should be followed closely as to price stability and financial stability.

In conclusion, it is expected that the contribution of demand to the decline in inflation in the upcoming period will remain limited compared to previous years.

Crude oil prices play an important role in the contribution of import prices to inflation. In 2005 crude oil prices displayed a substantial rise. Despite a downward trend in crude oil prices towards the end of the year, this trend remained temporary and prices restarted to increase in early 2006. This development confirms the forecasts that the upward trend in oil prices would also continue to be a risk factor with respect to inflation in 2006. Even if the current price level of crude oil is maintained, the effects of crude oil prices on inflation through input costs will continue for a while. Nevertheless, these effects are not expected to deteriorate medium-term expectations.

### ***Monetary Policy***

While making its decisions, the Monetary Policy Committee focuses on the consistency of the medium-term outlook of inflation with the targets by taking into account the lagged effects. The period, during which the lagged effects are most intense, covers around one and one and a half year period. No prompt responses are given to exogenous shocks, the medium-term targets are emphasized and policy response is spread over time. The Monetary Policy Committee's reaction to the increments in tobacco prices in December and to the rise in crude oil prices in January shall be evaluated within this framework.

Likely fluctuations in international liquidity conditions and global risk appetite are regarded as factors that create uncertainties with respect to the inflation outlook. Due to historic lows in long-term interest rates in developed countries, international funds have been flowing to developing countries that are taking important steps towards stability, such as Turkey. In the case that this trend is reversed, fluctuations may occur in financial markets. Even if recent developments provide some signals for the continuation of this trend in 2006, shocks arising in financial markets may have an effect on inflation within the context of current economic conditions in Turkey.

The Monetary Policy Committee has concluded that the recent data released since the last Monetary Policy Committee Meeting have not led to a significant change in the inflation and monetary policy outlook. It is estimated that although the downward trend of inflation might be interrupted in the first quarter of 2006, it would resume its trend starting from the second quarter of 2006. Despite this downward

trend, in the light of current data, year-end inflation is most likely to be above the 5 percent end-year target. The major reasons behind this argument are the sustained price rigidities in the service sector, the diminution of support provided by supply-demand conditions to inflation, the persistence of uncertainties about oil prices and international liquidity conditions and the fact that the other favorable factors have not been effective enough to offset these negative developments. As a result, it has been decided to keep the short-term interest rates at the CBRT Interbank Money Market and at the Istanbul Stock Exchange Repo-Reverse Repo Market unchanged.

In the light of currently available information, short-term interest rates are less likely to move upward in the medium-term, rather than going downward or remaining stable. In the near future, however, short-term interest rates are more likely to remain stable. This policy perspective will help inflation stay in line with the target path around mid-2007.

Meanwhile, it should be underlined that any new data and information associated with the inflation outlook in the next period will make the Monetary Policy Committee revise its stance about the future.

The Central Bank of the Republic of Turkey has adopted formal inflation targeting strategy as of January 2006. The first inflation report of the inflation targeting period will be published on the official website of the CBT on 31 January 2006. In the new period, the Inflation Report will be one of the main communication means of the Monetary Policy Committee. In the quarterly reports, recent economic developments will be explained and the general macroeconomic outlook will be evaluated so as to shed light on the course that medium-term inflation will assume. Additionally, inflation projections will be presented.