**No: 2007-07** **27 March 2007**

# SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 15 March 2007

## *Inflation Developments*

**1.** In February, consumer prices increased by 0.43% and the annual inflation rate rose up to 10.16% The rise in annual inflation can be mainly attributed to (i) tax-driven hikes in cigarette prices, (ii) early winter discounts in clothing, (iii) rise in processed food prices and (iv) the base effect of durable goods discounts of the same period last year. These developments led to an increase in the annual inflation of Special CPI aggregates, also suspending the downward trend of the annual rate of increase of the H index (CPI excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold). But, the annual inflation measured by the H Index is expected to resume its downward movement starting from the second quarter of the year.

**2.** After rising sharply in January, the annual inflation rate of unprocessed food prices exhibited a partial correction in February. Yet, the inflation in unprocessed food prices still remains very high. Energy prices, on the other hand, retraced their earlier run-up by March, after a slowdown in January and February, along with the recent upward movement in oil prices.

**3.** As regards the services group, the annual inflation of rents, hotels-restaurants and transportation services declined at a subdued level while the overall services inflation remained relatively unchanged as annual inflation in other sub-items of the services group continued to rise.

**4.** Besides, the Monetary Policy Committee (the Committee) noted the possible effects of administered price hikes on March inflation, which was highlighted at the previous meeting. The Committee foresees that the annual inflation might thus temporarily rise in March but will start to decline gradually by the second quarter.

## *Factors Affecting Inflation*

**5.** The Committee evaluates the recent data as broadly consistent with the outlook presented in the January Inflation Report:

**6.** The slowdown in private consumer demand continues. Seasonally adjusted automobile sales fell in January and February, while sales of white goods did not change since the last quarter of 2006. In addition, the consumer confidence indices do not suggest a noticeable change in semi- and non-durable goods demand for the first quarter of 2007. The leading indicators on private consumption demand also point that the seasonally adjusted private consumption will not reveal a significant change in the first quarter of 2007 compared to the last quarter of 2006.

**7.** Credit growth continued to slow down and so did the growth rate of other monetary indicators. Although bank lending rates declined gradually since late January, the current financing conditions, together with the tight liquidity conditions and the surging global volatility, continue to restrain credit expansion.

**8.** Investment demand and imports of capital goods did not change significantly compared to the last quarter of 2006, whereas the sales of commercial vehicles fell in January and February. On the other hand, the data on non-metallic minerals production and imports point to an ongoing robust activity in construction.

**9.** Foreign demand remains relatively strong. Exports keep growing as the productivity in the manufacturing industry continues to rise and the European economy preserves its robust economic activity, while imports are restrained by the slowdown in growth rate. Accordingly, January's trade volume indexes indicate that the growth rate in exports prevailed over imports. The ongoing high rate of export growth in February and March, as revealed by the Turkish Exporters' Assembly figures, suggests that the foreign demand continues to have a positive contribution on the growth rate.

**10.** Despite the ongoing decline in domestic demand, industrial production keeps its strength on the back of foreign demand, with an upswing in January mainly driven by base effects and the number of business days. Yet, controlling for these factors does not change the fact that industrial production still displays a significant rise. Moreover, capacity utilization rates and expectations of February suggest that the production will continue to rise.

**11.** To sum up, the Committee judges that aggregate demand conditions continue to support disinflation. Although economic activity is projected to recover gradually in the second half of the year, annual growth rate in GDP will be low in the second quarter owing mainly to base effects.

**12.** Recent data indicate that services employment growth continued to moderate since mid-2006, which supports the slowdown in economic activity. On the other hand, the co-existence of a remarkable slowdown in industrial employment with strong industrial production in 2007 suggests that labor productivity continues to rise.

**13.** Developments in other cost factors do not display a negative outlook in general. As the growth rate of the world economy becomes more balanced, the crude oil prices display a more stable course. However, it is not possible to make accurate projections regarding the oil prices in the medium to long-term. Moreover, the recent fluctuations in metal prices confirm that risks related to the commodity prices, as a whole, should not be disregarded.

**14.** Although the end-year inflation expectations displayed a slight upward movement in March, medium-term inflation expectations remained unchanged, yet significantly above the target. As inflation starts declining in the upcoming period, the expectations will gradually converge to the target.

***Monetary Policy and Risks***

**15.** While taking monetary policy decisions, the Committee focuses on whether the medium-term inflation outlook is consistent with the target. In other words, what matters for the conduct of monetary policy is the evolution of inflation in the medium run, rather than short-term temporary fluctuations. In this respect, a one-off rise in March inflation, led by administered prices, will not be crucial in the decision-making process, as it does not alter the medium-term inflation outlook.

**16.** CBT has not changed its policy rates since August 2006. The reduction in the risk premium and the improvement in inflation expectations have further tightened the policy stance since then. The cautious stance of monetary policy contained inflation expectations and thus the long-term interest rates. The fluctuations in international financial markets in early March induced the interest rates of government securities to rise. Yet, the interest rates came down soon, as the volatility was short-lived. The downward movement of bank lending rates since January moderated thereafter.

**17.** In sum, a joint evaluation of the current policy stance and other factors affecting inflation suggests that inflation will maintain a downward course in the upcoming period, converging to the targets in the medium run. Yet, several risks remain.

**18.** The main risk to the mid-term inflation outlook is the possibility of higher-than-expected downward persistence in inflation, manifested lately by the inertia in inflation expectations and services inflation. The current level of inflation expectations poses a risk to wage and price setting behavior and, thus, to the disinflation process. Moreover, services prices-related risks still prevail. Given the relatively low productivity in the services sector, the backward-looking price setting behavior and the sensitivity of services prices to wage hikes, relatively high services inflation should not fall as a surprise. However, even if these factors are taken into account, the services inflation still needs to fall below its current level in order to reach the medium term targets. The Committee, in this regard, continues to closely monitor services price developments.

19. The uncertainty concerning the lagged effects of monetary policy on aggregate demand still remains a risk to the inflation outlook. Although the impact of monetary tightening exercised since June 2006 on private demand has become noticeable recently, the cumulative impact is still to be seen. And the recent increase in government spending adds to this uncertainty. In this respect, the Committee closely monitors the indicators related to the overall economic activity.

20. The Committe has frequently emphasized the fact that waning risk appetite or a possible fluctuation in liquidity conditions in global markets continue to pose a risk against the inflation outlook. Indeed, the economic data announced in the United States, Japan and China delivered another bout of volatility in international markets in early March. Although these fluctuations were short lived and temporary, and did not deteriorate the inflation outlook, they indicate that uncertainties related to global liquidity conditions may continue in the period ahead. The Committee will not allow these possible fluctuations to have adverse effects on the medium-term inflation outlook.

21. In light of these developments, the Committee has assessed that meeting the medium-term inflation targets requires the maintenance of a cautious policy stance and decided to keep the policy rates on hold. The uncertainties in global economy, the gap between inflation expectations and targets and the risks to services prices inflation necessitate keeping a tight policy stance.

22. 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. Should any adverse developments affecting the medium-term inflation outlook presented in the January Inflation Report arise, the Central Bank will not hesitate to further tighten the monetary policy stance.

23. The continuation of the European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program remain of critical concern. Developments in structural reforms that would enhance the quality of fiscal discipline in the medium and long run are closely monitored both in terms of macroeconomic stability and price stability. Continued determination in implementing the decisive steps taken in these areas in recent years will strengthen the resilience of the economy against possible changes in the global conjuncture.