

## **SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING**

Meeting Date: 14 May 2007

### ***Inflation Developments***

1. Consumer prices increased by 1.21% in April, bringing annual inflation down to 10.72%. Yet, the surge in clothing prices restrained the decline in inflation despite the considerable slowdown in inflation of consumer durables and services.
2. The rise in the annual inflation of clothing and footwear can be attributed to the recent cost-driven hikes in apparel manufacturing prices. Recent course in clothing and footwear prices suggest that the price developments in this group will contribute less to the disinflation process in 2007 compared to 2005 and 2006. On the other hand, the prices of durable goods exhibited a favorable outlook in April, possibly owing to the strength of Turkish lira as well as the slowdown in domestic demand.
3. Recent price developments suggest that services inflation has been easing, albeit modestly. Annual services inflation dropped to its lowest level since September 2006. Monthly hikes in services prices from January to April fell behind the year-ago levels of the same period. Along with the slowdown in domestic demand, services inflation is expected to decline further gradually in the upcoming period, yet, the Monetary Policy Committee (the Committee) considers that this improvement may be limited given the backward-looking pricing behavior, the high-sensitivity of service prices to wage hikes and the relatively low productivity in this sector.
4. Monthly inflation in the housing utilities continued to ease in April. On the other hand, prices of petroleum products re-accelerated by a 6.13% rise in the last two months, slowing down the decline in headline inflation.
5. Although clothing prices displayed a sharp rise in April, the favorable developments in prices of durable goods and services pulled the annual inflation of all special CPI aggregates down. With the disappearance of the exchange rate pass-through effect of May and June 2006, the downward trend in the annual rate of increase of H index will be further noticed in the upcoming period.

6. Unprocessed food prices continued to rise dramatically, at a rate of 16.63% per annum. Fruit prices soared by 42.52% in the first four months of 2007, up from an average 3% monthly rise for the same period in 2005 and 2006. Due to warm weather conditions beyond seasonal norms, the declines in fresh vegetable and fruit prices, which normally take place in the summer season, may shift from June to May. Moreover, exchange rate movements and the subsequent pass-through in May 2006 constitute a high base on the consumer price index. In this regard, the Committee noted that a partial correction in unprocessed food prices, and the base effect may contribute to the decline in annual inflation in May.
7. In light of these developments, the Committee assessed that the awaited signs of disinflation have emerged in April and that the disinflation trend will be more significant in the upcoming period.

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

8. The Committee identifies the recent data on economic activity as broadly consistent with the outlook presented in the April Inflation Report.
9. The slowdown in private consumption demand continues. Consumer credits exhibit a pattern as outlined in the inflation report. Automobile loans continue to decrease in real terms. Housing loans are on a rise, albeit at a modest pace. Personal expenditure loans, on the other hand, continue to increase at a relatively higher rate but do not reveal a notable acceleration. Despite a limited fall observed recently, bank loan rates are still above the previous year's levels and continue to curb credit expansion.
10. Leading indicators suggest that the slowdown in domestic demand continues. Sales of automobiles and white goods fell in the first quarter of 2007 in seasonally adjusted terms. Falling domestic automobile sales in April signify that the private demand may continue to slowdown in the second quarter. The Committee judges that tightened financing conditions and growing uncertainties will continue to suspend the durable goods demand.
11. Foreign demand remains robust. The strong export performance compensates the negative impact of the slowdown in domestic demand on overall economic activity. Exports in the first quarter prevailed over imports in real terms. Leading indicators of April and May suggest that the strong export performance continues.
12. The robust external demand supports industrial production. As suggested by seasonally adjusted data, industrial production displayed a flat course in the first quarter. Despite the ongoing stability in industrial production, the fact that last year's production was highly volatile may lead to fluctuations in annual growth rates. Indeed, industrial production rose sharply by around 7.8% in the first quarter of 2007 owing to the base effect of last year's first quarter; however, in the

upcoming months, it may display low annual growth rates due to high base in the second quarter of 2006.

13. Imports of capital goods rose in the first quarter, whereas machinery-equipment investments were restrained by the low course of light commercial vehicle sales. April figures suggest that the slowdown in commercial vehicle sales continues. Production and import data on non-metallic minerals, on the other hand, do not refer to any significant slowdown in construction activities.
14. In sum, the recent data confirm the outlook presented in the April Inflation Report. Aggregate demand conditions continue to support disinflation. Demand for durable goods and machinery-equipment investment continue to ease, while strong external demand moderates the slowdown in overall economic activity.
15. The growth rate in services employment decelerated in the last three quarters. This trend is in line with the slowdown in economic activity. Moreover, industrial production remained relatively strong while industrial employment displayed a slowdown, suggesting that labor productivity continued to rise.
16. The recently elevated prices of crude oil and commodities add to the inflationary pressures via imported input costs and thus curb the disinflation process. These price movements are closely monitored.
17. Market expectations for end-year inflation increased slightly in April, possibly due to higher-than-expected inflation outturns. However, the medium-term inflation expectations have not deteriorated. Inflation expectations for the next 12 months have been improving modestly since early 2007, while those for the next 24 months stayed flat at around 5.5% in general. Medium-term expectations should move downward as the disinflation process accelerates in the upcoming period.

### ***Monetary Policy and Risks***

18. Global bond issues of foreign financial institutions in YTL and the robust privatization revenues have been increasing the supply of loanable funds. These developments exert a downward pressure on bank lending rates. However, the tight stance of monetary policy and the ongoing perceptions of uncertainty continue to restrain the demand for credit. Accordingly, consumer credits are expected to maintain their modest course in the upcoming period.
19. Other monetary indicators also display a similar outlook. Specifically, the gradual slowdown in the annual growth of banknotes in circulation since the second half of 2006 is noteworthy. However, the information included in monetary indicators should be handled with caution due to possible shifts in money demand arising from changes in portfolio preferences or financial system deepening.

20. The ongoing slowdown in private consumption and investment demand reveal that the monetary tightening since June 2006 is affecting the domestic demand as expected. Against this background, disinflation is expected to become more significant in the upcoming period. However, there are some remaining risks to the inflation outlook:
21. Possibility of stronger-than-expected inertia in inflation poses a significant risk for the medium-term inflation outlook. Currently, medium-term inflation expectations are not aligned with the targets. Although, the Committee expects the decline in inflation to deliver an improvement in inflation expectations in the period ahead, the current course of expectations continues to pose a significant risk to the inflation outlook through wage and price setting behavior.
22. Uncertainties over the lagged effects of monetary policy stand as a major risk to inflation outlook. The monetary tightening since June 2006 is affecting the domestic demand as expected. The lagged effects on inflation are yet to be seen. Although the rate of increase in durable goods and services prices decelerated in the recent period, these developments do not provide enough evidence to claim that the current inflation trend is in line with medium-term targets. In addition, the course of non-interest budget expenditures exacerbates the uncertainty over the lagged effects of monetary policy.
23. Recently, the developments on international liquidity conditions and global risk appetite have been in favor of developing countries. However, ongoing uncertainties concerning global economy and volatile commodity prices pose risk to inflation. Should any such shock threaten the medium-term inflation outlook, the Central Bank will react depending on the source of the shock.
24. The Central Bank does not respond to temporary fluctuations in inflation. Decisions of the Monetary Policy Committee are based on an overall evaluation of all factors affecting medium-term inflation, rather than temporary fluctuations in inflation. In other words, the Central Bank decisions are focused on achieving consistency between medium-term inflation and the targets. In this regard, although disinflation is expected to become more significant in the upcoming period, the Committee, with a medium term perspective, decided to keep the policy rates unchanged against the risks such as the gap between inflation expectations and targets, the backward looking pricing behavior, elevated oil prices, prevailing uncertainties, and the stickiness related to services price inflation.
25. Moreover, the potential impacts of the progress in the structural reform agenda and the developments in incomes policy as well as public sector non-interest expenditures on inflation and inflation expectations are carefully evaluated. Within this framework, the Committee assessed that meeting the medium term inflation targets requires the maintenance of the tight policy stance.

25. Prudent monetary policy is necessary but not sufficient for achieving price stability. The role of fiscal policy and structural reforms are also critical in this process. Developments in structural reforms that would enhance the quality of fiscal discipline are closely monitored both in terms of macroeconomic stability and price stability. The European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program also remain to be of concern. 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 economy.