No: 2007-09

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 18 April 2007

Inflation Developments

1. In March, consumer prices increased by 0.92% and the annual inflation rate rose up to 10.86%. The relatively high cumulative inflation in the first quarter can be mainly attributed to soaring fruit and vegetable prices and tax-driven price hikes in tobacco products. Surging tobacco prices pushed total consumer inflation up by 0.5 percentage points. The moderation in annual inflation of unprocessed food prices in March was basically driven by descending prices of items other than fruits and vegetables. The 11.74% rise in unprocessed food prices in the first quarter, due to an increase in fruit and vegetable prices above seasonal norms, highlights that the risks related to price developments in this group are still notable.

2. The increase in the prices of petroleum products accelerated in March parallel to the developments in the global oil market, but the annual inflation in the energy component of the housing subgroup eased. The first quarter rise in the overall energy index remained more modest compared to the previous year.

3. Annual goods inflation ascended in the first quarter, mainly due to the base effect resulting from the decline in prices of particularly durable goods associated with the appreciation of TRY in the first quarter of 2006. Moreover, first-quarter discounts in clothing remained below year-ago levels and added to the annual goods inflation. These developments altogether led to an increase in the annual inflation of Special CPI aggregates.

4. The annual rate of increase in the prices of several services sub-items has been displaying a limited slowdown, yet there has been no significant improvement in the overall pricing behavior. However, the slowdown in domestic demand is expected to have lagged effects on services prices.

5. In addition, a notable base effect stemming from last year’s market turbulence and the adverse supply shocks such as the hikes in energy and unprocessed food prices is expected to ease annual inflation in the coming months. Accordingly, the disinflation trend is expected to become discernible starting from the second quarter of 2007.

Factors Affecting Inflation

6. The Monetary Policy Committee (The Committee) identifies the recent data on economic activity as broadly consistent with the outlook presented in the January Inflation Report:

7. The slowdown in private consumption demand continues. The sustained decline in automobile and white goods sales in the first quarter signifies that the slowdown in demand for durable goods continues to curb private consumption. The data on consumer credits, another indicator of consumption expenditures, also suggest a similar outlook. Motor vehicle loans continue to decrease, while other sub-items of consumer credits do not reveal a notable increase compared to the second half of 2006. These developments coupled with the high base of the first half of 2006 reveal that annual growth in private consumption expenditures will not display a significant change in the first half of 2007.

8. Foreign demand remains relatively strong. The negative impact of the slowdown in domestic demand on economic growth is largely compensated by the robust foreign demand. In the first two months of 2007 exports increased more than imports in real terms. Leading indicators on March and April figures suggest that the strong export performance continues.

9. Investment expenditures did not change notably over the last quarter of 2006. In January and February, seasonally adjusted capital goods imports rose over the fourth quarter of 2006, whereas commercial vehicle sales dropped, driven by light commercial vehicles. Manufacturing of electrical machinery and electronics maintains its quarter-ago levels. On the other hand, data on construction permits suggest that the construction sector continues to grow at a rapid pace.

10. Although In January and February the industrial production index displayed high annual growth rates, this development mainly owes to the base effect. Seasonally adjusted data do not refer to any acceleration in industrial production. The ongoing favorable export performance supports industrial production, but the slowdown in domestic demand constrains it. The fact that exports remained robust in March indicates that industrial production maintained its upward trend in March, albeit at a slower pace than in January and February. Between April and June, industrial production may temporarily display low annual growth rates led by base effects.

11. In sum, strong foreign demand is expected to support growth in the first half of the year, but the slowdown in domestic demand will continue to restrain the aggregate demand. In this respect, aggregate demand conditions will support disinflation.

12. Recent data indicate that employment in services maintained a modest growth rate since July 2006. This trend is in line with the slowdown in economic activity. Moreover, export-led industrial production remained relatively strong while industrial employment displayed a slowdown over the last quarter of 2006, suggesting that labor productivity continued to rise.

13. The recent surge in crude oil prices is worth noting and the concurrent rise in other commodity prices increases the risks related to cost-push shocks. The elevated levels of the oil and other commodity prices require close monitoring.

14. In the recent period, end-2007 inflation expectations displayed a slight increase possibly owing to the high inflation outturns in the first quarter. Yet, the medium-term inflation expectations have not deteriorated, pointing that the agents perceived the rise in inflation temporary. However, the Committee considers the gap between medium-term inflation expectations and the targets as a risk to price setting behavior.

Monetary Policy and Risks

15. Private consumption demand continued to slow down in the first quarter. This development suggests that the transmission mechanism of monetary policy began to function significantly. Yet, the increased caution in spending behavior of economic agents, due to heightened risk perceptions, added to the slowdown in private consumer demand.

16. Recently, increasing domestic market liquidity coupled with improved external borrowing conditions has eased credit supply conditions. The declining need to keep high rollover ratios in Treasury's debt servicing, and CBT's FX buying auctions contribute to the rise in the market liquidity. Another factor to help enhance banks' borrowing facilities is the favorable course of TRY-denominated bonds issued by foreign institutions. In addition, non-residents continue to raise their holdings in Turkey. A joint evaluation of all these developments reveals that banks' loanable funds are on a rise.

17. Despite the improvement in credit supply conditions, the high level of bank loan rates, backed by CBT's cautious stance, continues to restrain credit demand. Although the interest rates on loans have recently fallen, they still remain very high compared to the first quarter of 2006. Therefore, unless interest rates fall down to lower levels, the growth rate in consumer credits will remain contained in the short term.

18. The Committee reviewed the inflation projections to appear in the April Inflation Report and concluded that there had been some developments that would necessitate an update in the inflation outlook presented in January Inflation Report. These developments can be listed as follows:

19. Firstly, considering the revisions in the 2006 GDP figures, the lagged contribution of demand conditions to disinflation is now assumed to be slightly less than the level set out in the January Inflation Report. Secondly, the Committee observed that unprocessed food prices still lack the expected correction and that tobacco products suffered tax-driven price hike. Furthermore, the decrease in annual services inflation is deemed to be less-than-expected, although some sub-items displayed improvements. Lastly, oil-price assumption is revised upward with regard to the surges in oil prices. Consequently, inflation forecasts are revised up.

20. The above-summarized updates indicate that further caution might be required compared to the January Inflation Report of 2007, to make sure that the medium-term outlook is consistent with the targets. Therefore, the Committee decided to enhance the cautious policy stance, as stated in April Inflation Report, against the risks such as the gap between inflation expectations and targets, the backward looking pricing behavior, increase in oil prices, prevailing uncertainties, and the stickiness related to services price inflation.

21. 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.

22. A joint evaluation of the current policy stance and other factors affecting inflation suggests that the disinflation trend will become more discernible starting from the second quarter of the year. However, risks remain to inflation outlook:

23. The monetary tightening since June 2006 is affecting the domestic demand as expected. The lagged effects on inflation are yet to be seen. Recent data is broadly consistent with the main outlook presented througout the Inflation Reports since July 2006. The impact of monetary tightening in the second half of 2006 on the demand is visible especially through the slowdown in the expenditures of durable goods and machinery-equipment. Robust performance of exports has been offsetting the contractionary impact of the slowdown in private domestic demand and contributing positively to the economic growth rate. Nevertheless, uncertainties over the monetary transmission mechanism prevail to be a risk for medium-term inflation outlook. While the recent hikes in public expenditures seem to further blur the outlook, the proposed cut-down in certain non-interest public expenditure items have somewhat relieved these concerns. In sum, a lower-than-expected impact of slowdown in domestic demand on inflation still remains as a risk factor. Should such a risk materalize, the CBT may further tighten the policy stance.

24. Another risk related to the medium-term inflation outlook is the stickiness in inflation expectations and backward looking price setting which would lead to a higher-than-expected inertia in the disinflation process. The improvement in inflation expectations came to a halt in the last three months. Although the expectations should come down gradually as the headline inflation eases, the sticky medium-term inflation expectations remain to be a risk for the inflation outlook through its possible reflections on the price and wage setting behavior. The CBT will keep its cautious stance for an extended period should such risk materialize.

25. Possible fluctuations in global markets remain as a risk to the inflation outlook. The prevailing uncertainties on the US economy and on global imbalances still have the potential to trigger fluctuations in international markets which may have adverse impact on emerging economies. Moreover, the elevated levels of the oil prices do not help to ease the risks related to global financial markets. On the other hand, the Treasury's strong cash accounts and the recent slowdown in the deterioration of the current account have the potential to mitigate the impact of possible fluctuations in the financial markets. In what so ever, should a shock lead to heigthened perception of uncertainty, the CBT will retain the medium-term perspective and announce the appropriate strategy to bring inflation back to the target.

26. Prudent monetary policy is necessary but not sufficient for achieving long-run 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 in the medium and long run 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.