

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

Meeting Date: May 15, 2008

### ***Inflation Developments***

1. Consumer prices were up 1.68 percent in April and annual inflation rose to 9.66 percent. The rise in inflation was largely driven by increases in food and oil prices and lagged effects of exchange rate movements. The surge in food and energy prices accounted for about 6.3 percent of the annual inflation rate by April.
2. The unprocessed food inflation slowed to an annualized rate of 6.73 percent on the back of a partial correction, driven by improved weather conditions. In contrast, processed food prices continued to rise at a strong pace, with an annual rate of increase of more than 20 percent in April. Annual inflation in processed food prices is expected to remain at elevated levels for a while.
3. Energy prices rose by 1.54 percent in April to an annual rate of 17.49 percent. The surge in world oil prices and the depreciation of the Turkish lira pushed fuel oil prices higher by 4 percent in April. Fuel oil prices are expected to further increase in May. The surge in international oil prices also puts upward pressure on natural gas and electricity prices. The potential hikes in electricity tariffs implied by the automatic price adjustment mechanism creates short term upside risks on domestic energy prices.
4. Annual inflation in goods excluding energy and unprocessed food increased by 1.6 percentage points to 8.55 percent, driven primarily by soaring processed food prices coupled with exchange rate pass-through to domestic inflation. The lagged effects of exchange rate developments are predicted to put further pressure in May on the consumer prices, especially through durable goods.
5. The steep rise in food and energy has been having adverse effects also on services inflation. Catering prices rose by 1.86 percent and prices for transport services were up 1.72 percent, recording an annual rate of increase of 13.03 and 11.44 percent, respectively. Prices for services other than catering and transport, however, maintain a slower rate of increase.
6. The Monetary Policy Committee (The Committee) noted that inflation will remain elevated in the short term owing to lagged pass-through from exchange rates and supply shocks, yet it will start decelerating by the last quarter of 2008.

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

7. Recent readings are in line with the outlook presented in the April Inflation Report. Industrial production grew at an annualized rate of 2.4 percent in March, but was down 1.7 percent from February on a seasonally adjusted basis. Based on quarterly averages, industrial production increased by a solid 6.9 percent annual rate during the first quarter of 2008, but fell by 0.7 percent from the previous quarter in seasonally adjusted terms. On balance, these figures indicate that, despite the recent slowdown in economic activity, the economy will display a relatively sizeable annual growth in the first quarter of 2008, mainly benefiting from the base effect.
8. Indicators for consumer demand point to an ongoing slowdown in domestic demand. The seasonally adjusted CNBC-e consumption index continued to trend downward in April, following the decline in the first quarter. Consumer confidence indices and seasonally adjusted sales of automobiles continued to decline in April. Moreover, first-quarter domestic sales of white goods lagged behind the fourth quarter of 2007 on a seasonally adjusted basis.
9. Leading indicators for private sector investments reflect a similar outlook to consumer demand. The production of electrical machinery and appliances and the domestic sales of light commercial vehicles registered a strong annual growth rate during the first quarter; however, both indicators were down from a quarter ago in seasonally adjusted terms. Machinery-equipment production, on the other hand, declined both on annual and seasonally adjusted terms. Imports of capital goods remain strong on a year-on-year basis, yet seasonally adjusted figures point to a slowdown. Besides, the production of nonmetallic minerals continues to fall, suggesting further weakening in construction activity.
10. The economic slowdown is also evident in service-sector employment figures, which displayed a limited rise in the first quarter in seasonally adjusted terms.
11. Both exports and imports recorded high growth rates in the first quarter of 2008. During this period, exports grew faster than imports in real terms. Leading data released by the Turkish Exporters' Assembly suggest that exports have continued to grow at a robust pace in April and May.
12. In sum, difficulties in international credit markets continue to restrain domestic demand, while external demand remains robust. Overall, aggregate demand conditions will continue to support disinflation.

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

13. Moderating domestic demand has been curbing the pass through from cost-push factors. The prices of products that do not use food or energy as main inputs have been rather well behaved. However, the fact that first round effects of the supply side shocks have reached unprecedented levels has been affecting inflation expectations adversely. In this regard, the Committee decided to implement a measured hike in policy rates to contain the potential second round effects.
14. Inflation is expected to start decelerating in the last quarter of the year, ending 2009 at around 6.7 percent, as forecasted in the April Inflation Report. In the forthcoming period, monetary policy decisions will be geared towards keeping inflation close to these forecasts. In this respect, the Committee highlighted the importance of economic agents' forecasts to be aligned with the Central Bank forecasts.
15. Risks to the inflation outlook exist on both sides:
16. Continued rises in energy prices and ongoing uncertainty in the global economy have increased the risks on the short-term inflation outlook. The Committee indicated that oil prices have materialized at higher levels than the path implied by our baseline projections in the April Inflation Report. Developments in food prices, on the other hand, have been relatively more favorable. Although processed food prices continued to rise due to lagged impact of past developments, they are likely to decelerate on the back of recent moderation in agricultural commodity prices. Moreover, inflation in unprocessed food items has been easing recently, mainly owing to benign weather conditions. Overall, the Committee assessed that at this point there is no need to alter the main scenario on food prices presented in the Inflation Report.
17. The fact that the economy has faced persistent and sizeable supply shocks, concurrently with deterioration in overall market sentiment, implies that inflation may display more inertia than envisaged. In this respect, the uncertainty in food and energy prices also poses risks for the medium term outlook. The Central Bank will aim at containing the second round effects should the food and energy prices continue to rise at a rapid pace. More favorable developments than envisaged, on the other hand, will be perceived as an opportunity to implement a faster disinflation.
18. The extent of the slowdown in the global economy is yet to be seen and the volatility in the financial markets still continues to be a major source of uncertainty. A protracted period of uncertainty has been keeping risk appetite at low levels and leading to a slowdown in capital flows to emerging markets. The Committee once again emphasized that monetary policy would not react to temporary fluctuations in financial markets, but will not hesitate to implement the necessary monetary

tightening should the volatility in the financial markets translate into a generalized deterioration in the pricing behavior. The Committee also underlined that existing conditions in the money market allow the Central Bank to implement an effective liquidity management.

19. The Committee underscored that it would be more beneficial if any need to tighten the fiscal balance, in order to meet the targets implied by the Medium Term Financial Framework, would in principle be implemented largely through expenditure cuts rather than higher excise taxes. Moreover, it was stated that pre-announcing a schedule or a rule regarding the likely adjustments in administered prices and taxes would help to alleviate the level of dispersion in inflation expectations.
20. In sum, the Central Bank will continue to take the necessary measures to prevent the potential second-round effects of the adverse developments in food and energy prices. Accordingly, the Committee will consider the possibility of a further measured rate hike in the next meeting. The Committee emphasized that the policy stance presented in the Inflation Report should by no means be perceived as a commitment, as any new data or information related to the inflation outlook might lead to a revision in the monetary policy stance. Consequently, the Committee stated that the extent and timing of possible future rate hikes would depend on developments in global markets, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.
21. Prudent monetary policy is necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. In this respect, the European Union accession process and the implementation of structural reforms remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance the productivity, are monitored closely with regard to their implications on macroeconomic and price stability.