No: 2008-16 **26 June 2008**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: June 16, 2008

Inflation Developments

1. Consumer prices increased by 1.49 percent in May and annual inflation rose to 10.74 percent. The rise in food and energy prices continued to be the major driver of inflation, accounting for about 7 percentage points of annual inflation as of May.

2. The year-on-year rate of increase in food and nonalcoholic beverages surged to an all-time high of 15.69 percent since the inception of the new consumer index in 2003. Even though fresh fruit and vegetable prices displayed some correction, inflation in other unprocessed food prices continued to rise, driving up annual inflation in overall unprocessed food to 8.26 percent in May. Yet, a further correction in fresh fruit and vegetable prices is likely to be observed in June as well. Meanwhile, the processed food prices continued to accelerate in May, pushing the group's annual inflation as high as 22.83 percent. Sub-groups, particularly bread and grain prices and prices for oils and fats, continued to increase markedly. The annual inflation in processed food prices is expected to remain elevated for some time.

3. Energy prices were up 0.77 percent in May to an annual rate of 17.70 percent, as fuel prices rose by 2.58 percent due to record-high world oil prices. Domestic energy prices are likely to continue increasing in the short term on the back of the adoption of automatic price adjustment mechanism in setting electricity tariffs.

4. Inflation in goods excluding energy and unprocessed food increased by 1.35 percentage points to an annual rate of 9.90 percent in May, of which 7.40 percentage points can be explained by the rise in processed food prices.

5. The impact of higher food and energy prices on services inflation continued into May. Prices for catering and transport services have shown a monthly increase of 1.82 and 1.79 percent, respectively, which together accounted for almost half of the annual services inflation rate of 9.86 percent. The Monetary Policy Committee (the Committee) noted that prices for services other than catering and transport remained relatively flat, and that the annual rental inflation registered a decline of 6 points over the past one year.

6. Core inflation indicators have continued to rise due to first and second round effects of the ongoing supply shocks. The Committee stated that inflation is expected to decelerate starting the final quarter of the year, although base effects are likely to keep annual inflation at elevated levels in the short term.

Factors Affecting Inflation

7. Data available for the first half of the year suggest an ongoing moderation in the economic activity. During the first four months, industrial production was nearly unchanged from the last quarter in 2007 on a seasonally adjusted basis.

8. The global credit crunch continues to restrain domestic demand. The seasonally adjusted CNBC-e consumption index continued to decline during April and May. Domestic sales of automobiles and white goods and imports of consumer goods also indicate a similar picture. The Committee emphasized that the chemical production, which is sensitive to changes in domestic demand, fell significantly in both monthly and annual terms between March and April. Moreover, imports of consumer goods were down from the first-quarter average in April in seasonally adjusted terms.

9. The CNBC-e consumer confidence index, which has been falling since the last quarter of 2007, also remained weak in May. Moreover, recent data indicate that real consumer loans further moderated in April and May.

10. The Committee assessed that soaring food prices and ongoing uncertainties continue to curb the domestic demand. Indicators from the Consumer Tendency Survey, especially on households' willingness to purchase semi-durable and durable goods, lend support for this assessment.

11. Global and domestic uncertainties have been slowing down the investment demand. The Committee noted that the number of newly established firms has dropped over the first half of 2008, indicating an ongoing moderation in business investment.

12. Despite the positive outlook for external demand, machinery-equipment production continued to flatten in April. The decline in domestic sales of commercial vehicles during the first quarter accelerated in April and May, confirming the slowdown in investment demand. Imports of capital goods, which displayed a slowdown in the first quarter, further continued to moderate in April on a seasonally adjusted basis.

13. After having remained flat in 2007 on the back of slowing construction activity, the production of nonmetallic minerals grew by an annual rate of 6.9 percent during January-April 2008, making a positive contribution to industrial production. Although the first-quarter rise in construction employment suggests a rebound over the previous year, tightening credit conditions and ongoing uncertainties are expected to put more pressure on the housing market. In fact, households' willingness to purchase a new house has been declining, as suggested by the Consumer Tendency Survey.

14. Labor market conditions improved slightly during the first quarter, mainly driven by the manufacturing industry employment. In contrast, the service-sector employment has

slowed down further. Accordingly, the Committee indicated that the recent trend in non-farm employment contain the unit labor costs and consumer demand.

15. External demand has remained relatively strong. Seasonally adjusted figures indicate that external demand in April was stronger compared to the first-quarter average. As suggested by the robust pace of exports and the marked slowdown in imports, net exports are expected to make a positive contribution to economic growth during the second quarter of the year.

16. In sum, recent readings on supply and demand conditions have been largely in line with the predictions of the April Inflation Report. Accordingly, aggregate demand conditions continue to support disinflation.

Monetary Policy and Risks

17. The Committee reassessed the inflation outlook presented under three alternative scenarios in the April Inflation Report. Recently there have been favorable developments in unprocessed food prices, while oil prices have followed a significantly higher course than the prices assumed in the baseline scenario in the April Inflation Report. Consequently, inflation is expected to decelerate starting from the last quarter of the year, ending 2009 close to the 7.5 percent inflation target.

18. The Committee emphasized that tighter credit conditions and the weakening in consumer confidence have continued to moderate domestic demand, hence supporting disinflation. Relatively moderate pace of inflation in services excluding transport and catering—items sensitive to food and energy price developments—support this view. Nevertheless, persisting supply side shocks continue to delay disinflation, having adverse effects on inflation expectations. In this respect, monetary tightening exercised in May and June should be perceived as an attempt to coordinate inflation expectations around the revised targets and thus to prevent the materialization of second round effects. Adverse impacts of the supply side shocks on the economy will be more limited should the economic agents align their expectations for the next three years with the target rates of 7,5 percent, 6.5 percent and 5.5 percent, respectively.

19. The Committee also assessed the liquidity projections and the liquidity management strategy. Excess liquidity sterilized in the overnight market has been shrinking in the second half of 2008 due to a reduction in the amount of FX purchased through regular auctions, fall in Treasury's foreign debt rollover ratio, and rising money demand. Accordingly, the Central Bank has provided the required liquidity into the system via repo auctions, targeting overnight interest rates to materialize at levels close to Central Bank borrowing rate. Current projections do not point to a permanent shortage in liquidity. Accordingly, overnight interest rate in the money market will be

targeted to stay close to the Central Bank borrowing rate in the forthcoming period. Hence, Central Bank's overnight borrowing rate will continue to be the key policy rate.

20. Main risks to the inflation outlook can be listed as follows:

21. Developments in oil prices continue to pose risks on inflation all over the world. The automatic adjustment mechanism in electricity tariffs, to be launched soon, is likely to further increase the domestic energy prices. Considering the ongoing uncertainties regarding energy prices, the Central Bank will continue to provide the inflation outlook under alternative scenarios.

22. The persistence of global inflationary pressures is yet to be seen and the impact of ongoing difficulties in the financial system on the overall economy still continues to be a major source of uncertainty. A protracted period of global 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.

23. In sum, the Committee stated that ongoing uncertainties and supply side shocks continued to pose risks on inflation, and that the Central Bank would consider a further measured rate hike when needed, so as to prevent the potential second-round effects of such risk factors. Accordingly, upcoming data related to inflation outlook will be monitored carefully. The extent and timing of a possible future rate hike will depend on developments in global markets, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.

24. 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.