

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: March 19, 2008

Inflation Developments

1. Consumer prices rose by 1.29 percent in February, bringing annual inflation to 9.10 percent. The rise in annual inflation was mainly driven by the sharp increase in unprocessed food prices, as highlighted in our previous Summary of the Monetary Policy Committee Meeting. The annual CPI inflation excluding unprocessed food remained unchanged from the preceding month.
2. In February, food prices were up by 5.05 percent, recording the highest monthly increase since the introduction of the 2003-base-year index. Fresh vegetable prices displayed an unusual rise due to adverse weather conditions. On the other hand, the high rate of increase in February also brings about the possibility of a correction in vegetable prices in March. Processed food inflation also remained on an upward trend. Bread and cereal prices have continued to increase in response to elevated domestic and global wheat prices. Moreover, higher import prices for food manufacturing industries put upward pressure on processed food prices through both intermediate goods and imported final consumer goods. Therefore, prices of processed food other than bread and cereal have also shown high rates of increase. Accordingly, the course of processed food prices remains as a risk, as it was highlighted in the January Inflation Report.
3. Energy prices increased by 0.30 percent in February, raising this group's annual inflation rate to 16.35 percent. Prices of domestic fuel products went up by 0.83 percent along with rising world oil prices, while prices of energy-related housing utilities remained almost unchanged. The current elevation of oil prices not only poses a threat to domestic fuel prices, but also puts upward pressure on prices of energy-related housing utilities. The energy prices in CPI are expected to rise further in March.
4. The year-on-year increase in prices of goods excluding energy and unprocessed food has been flat for the third consecutive month. In terms of the sub-groups, clothing and footwear inflation continued to decelerate in annual terms. The annual inflation in consumer durables was slightly down in January. Gold prices, on the other hand, continued to add pressure on headline inflation.
5. Services inflation continues to decelerate. The annual rate of increase in rents moderated further in February to 15 percent. The steady decline in rent

inflation for the past ten months is considered to be a favorable development by the Monetary Policy Committee (the Committee). Yet, price hikes in catering and transport services due to soaring food and energy prices curbed the downtrend in services inflation.

6. Against this background, the Committee assesses that rising global uncertainty and the adverse developments in food and energy prices may lead to some delay in reaching the inflation target. Moreover, it should be noted that last year's base effect may lead to an upward trend in annual core inflation indicators, starting from the second quarter of the year.

Factors Affecting Inflation

7. The Gross Domestic Product (GDP) growth rate for January-September 2007 is revised upwards to 5 percent from 3.8 percent, due to the new methodology employed by the TURKSTAT. The revision did not bring a major change for the main trends in the GDP growth. The average quarterly GDP growth rate, which was 2.2 percent between 2003Q3-2006Q2, has become 0.8 percent in the 2006Q3-2007Q3 period following the strong monetary tightening.
8. Current indicators suggest that the output continues to grow at a moderate pace. Industrial production in January increased by 11.7 percent annually, consistent with the assessment of the Committee in the February meeting. When corrected for the the number of working days, annual rate of growth in the industrial production drops to 5.2 percent, pointing to a considerable base effect. Seasonally adjusted industrial production in January is higher than the December figures, yet still below the levels recorded in October and November. February export figures and other leading indicators suggest that industrial production continues to grow, albeit at a moderating pace.
9. Domestic automobiles sales, one of the key indicators for consumer demand, has shown high growth rates in annual terms during the first two months of the year, but remained well below the levels recorded in the last quarter of 2007 in seasonally adjusted terms. Domestic sales of white goods in January 2008 fell by 18.9 percent in annual terms. After adjusting for seasonality, white goods sales fell significantly from the previous month, and have been lower than the 2007-fourth quarter levels. Similarly, the monthly average of the seasonally adjusted CNBC-e Consumption Index for January-February period was also below the level observed in the previous quarter. Moreover, according to CBT's Consumer Tendency Survey, spending on automobiles, houses, durables and semi-durables remained low. Consumer confidence indices have been declining since September. Consumer credits have continued to moderate during the first quarter of 2008, due to uncertainties in global credit markets.

10. On the other hand, imports of consumer goods continued to accelerate in January both in annual and monthly terms. However, the tightening in credit conditions and the recent developments in exchange rates are likely to curb import growth.
11. Investment spending has continued to slow down. The growth rate of private machinery-equipment investments was revised downward for the first nine months of 2007. The revision revealed that machinery-equipment growth rate in investments was declining during this period. Recent machinery-equipment production figures indicate that investments remain on a downward track. Seasonally adjusted machinery-equipment production, which had decreased on a quarterly basis starting from the second quarter of 2007, declined both in annual and quarterly terms in January. Electrical machinery production also went down in January in seasonally adjusted terms. Imports of capital goods, on the other hand, continued to rise sharply in January both on a yearly and monthly basis. Despite the rebound in January-February period, sales of heavy commercial vehicles are still below the levels recorded during the times of vigorous domestic demand.
12. Non-metallic mineral production, which is among key indicators of construction activity, remained unchanged in 2007 in annual terms. Seasonally adjusted figure for January 2008 was below the average level of the previous quarter. The turmoil in global financial markets and its likely impact on the domestic economy signal that the slowdown in the construction industry may continue. CBT's Consumer Tendency Survey data on "consumers' likeliness to buy or build a house during the next twelve months" support this outlook.
13. Deterioration in the overall investment sentiment is also evident in the results of Istanbul Chamber of Industry's (ICI) Economic Outlook Survey for the second half of 2007. Accordingly, corporate profitability fell substantially in annual terms. While the number of firms making new investments fell partly due to decreases in profitability, we observe an increase in firms' tendency to invest abroad.
14. External demand maintained its steady growth during the first quarter. According to data from Turkish Exporters' Assembly, annual export growth measured in US dollars amounted to 40.7 percent in February, and leading indicators for March also suggest a strong export growth in nominal terms. Since exports are growing largely due to movements in the terms of trade, the quantity indexes could provide a better indicator for the underlying trends in exports. In that sense, the robust growth in seasonally adjusted quantity indexes during January reveal that exports remain strong.
15. The slowdown in the economic activity is also evident in the non-farm employment data for the fourth quarter of 2007. The fourth-quarter non-farm

employment remained unchanged from a year earlier, whereas non-farm unemployment rate rose by 0.4 percentage points annually and reached 12.6 percent. Seasonally adjusted non-farm unemployment, on the other hand, declined for the first time since the second quarter of 2003.

16. In conclusion, although the readings related to the first couple of months of 2008 indicate an ongoing but moderating growth, deepening problems in international credit markets have increased the downside risks.

Monetary Policy and Risks

17. Increased volatility in financial markets and tightened credit conditions are likely to restrain the domestic demand in the forthcoming period. Accordingly, the Committee assessed that aggregate demand conditions will continue to support disinflation.
18. Recent rise in the market interest rates can mostly be attributed to the reflections of global risks on the domestic environment. Movements in exchange rates resulting from the financial market volatility may have adverse effects on inflation in the short term. On the other hand, given the weak demand conditions, exchange rate pass-through should be relatively limited at this point.
19. Notwithstanding the moderation in domestic demand, some risks remain for the inflation outlook:
20. Recent research conducted by the staff of the Central Bank of Turkey (CBT) suggests that economic agents lately have been attaching more weight to past inflation in forming their expectations. This observation implies that accumulated impact of the hikes in food and energy prices not only puts delay on the disinflation process but also impedes the improvement in inflation expectations. Besides, the movements in exchange rates and the heightened risk aversion may have further adverse impact on inflation expectations. Deterioration in inflation expectations has increased the uncertainty regarding the second round effects of the supply side shocks, thereby highlighting the risks of higher-than-envisaged inertia in inflation dynamics. Yet, medium term inflation expectations still point to a declining inflation trend, indicating that inflation targets, to some extent, continue to serve as a medium term anchor. The Committee will continue to monitor the main trends in inflation expectations closely.
21. Uncertainties in the global economy pose risks to the inflation outlook through possible portfolio effects and thus movements in exchange rates. The

difficulties in the money and capital markets of the developed economies continue, despite the relevant measures taken by the central banks. This process also affects the domestic markets. The CBT monitors the developments in financial markets with caution.

22. Maintaining the prudent fiscal policy is of utmost importance under current circumstances. Our medium term projections are based on the assumption that government expenditure targets will be met in 2008. Moreover, we assume that any extra need to readjust the primary budget balance will be implemented through expenditure cuts rather than hikes in indirect taxes. Any deviation from this assumption may alter the inflation and monetary policy outlook.
23. The Committee assessed that rising global uncertainty and the adverse developments in food and energy prices might lead to some delay in reaching the inflation target. Monetary policy remains focused on attaining the 4 percent inflation target in the medium term. However, reacting aggressively to supply-side shocks would lead to undesired fluctuations in the output. Therefore, current conditions necessitate the need to remain flexible. In that sense, the period inflation reaches the target may vary depending on the developments in commodity and financial markets.
24. In sum, ongoing uncertainties in the global economy and the risks to the price setting behavior have increased the need for the monetary policy to be more cautious. The Committee will continue to closely monitor the second round effects of the elevated food and energy prices. Monetary policy remains restrictive even after the recent rate cuts. Future rate cuts will depend on developments regarding global market conditions, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.
25. The support from fiscal policy and structural reforms are critical in preserving the resilience of the economy under current conditions. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain crucial. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance the productivity, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.