

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: August 14, 2008

Inflation Developments

1. Consumer prices increased by 0.58 percent in July, pushing annual inflation up to 12.06 percent due to soaring energy prices and the base effect from food prices. Food and energy items have accounted for 8.17 percentage points of annual inflation as of July.
2. The Monetary Policy Committee (the Committee) noted the relative deceleration in processed food inflation. Bread prices, in particular, increased only slightly in July after having accelerated significantly in the first half of the year, while vegetable oil prices continued to rise, albeit at a lower rate. The Committee expects the processed food inflation to ease in the remainder of the year. On the unprocessed food prices front, annual inflation increased to 3.75 percent due to the low base from a year earlier. Although drought conditions continue to put upward pressure on pulse prices, fruit and vegetable prices are expected to display a relatively more favorable course.
3. Energy prices increased by 5.79 percent in July on the back of the sharp rise in electricity and solid/liquid fuel prices. Consequently, annual energy price inflation rose to 26.87 percent. Hikes in electricity prices contributed by about 0.5 percentage points to monthly inflation in July. In August, the increase in natural gas prices is expected to add around 0.15 percentage points to inflation; yet, the fall in fuel prices driven by lower oil prices will limit the rise in energy price inflation.
4. The annual inflation in prices of goods excluding energy and food remained unchanged from a month ago, at 4.20 percent. Seasonal discounts led to a higher rate of decline in clothing prices compared to previous years. The slowdown in both domestic and foreign demand had a dampening effect on clothing prices. The strengthening of the new Turkish lira and the moderating domestic demand put downward pressure on prices of durable goods; yet white goods remained on the rise.
5. Lagged effects of supply shocks continued to have an adverse impact on services prices. The year-on-year inflation in prices for transport and catering services picked up further in response to a sustained rise in food and energy prices, whereas rental rates continued to decelerate.

6. The annual rate of increase in the widely cited core CPI indexes, denoted by H and I, went slightly up in July on account of lagged effects from supply shocks and the base effect. Seasonally adjusted monthly inflation figures, however, pointed to a slowdown in these indicators. In view of the downtrend in underlying inflation over the past two months and the decline in oil prices, the Committee expects inflation to moderate gradually in the forthcoming period.

Factors Affecting Inflation

7. Recent data indicate that economic activity has continued to slow down. After having expanded by 6.9 percent year-on-year in the first quarter, industrial production moderated to an annual growth rate of 3.1 percent during April-June 2008. In seasonally adjusted terms, industrial production remained flat over the first half of the year.
8. Early indicators suggest that domestic demand in the second quarter has been weaker than the first quarter. Consumer confidence indices stayed at lower levels than the first quarter, and the growth in real consumer loans have further slowed down. The seasonally adjusted consumption indices, the production of chemicals, domestic sales of automobiles, and imports of consumer goods went down during January-June 2008. In contrast, domestic sales of white goods recovered in the second quarter, although the production in the industry remained flat.
9. Domestic uncertainties and the depreciation of the new Turkish lira against major currencies had an adverse impact on investment demand in the second quarter. The production of machinery-equipment declined further in seasonally adjusted terms, while imports of capital goods fell for the second quarter in a row. Moreover, domestic sales of commercial vehicles suggested that machinery-equipment investments were slightly down from the first quarter.
10. The annual growth rate in export quantity index was 18.2 percent year-on-year in the first quarter, but declined to 9.1 percent in the second quarter. Seasonally adjusted figures pointed to an ongoing, yet moderating export growth. Recently, downside risks on global economy have increased, especially indicators for Euro area pointing to a slowdown. The Committee assessed that external demand could be adversely affected, should this outlook persist.
11. Regarding demand indicators for the third quarter, consumer confidence indices rebounded slightly in July, yet still remained at low levels. Meanwhile, real consumer loans continued to grow at a subdued pace. In this context, the Committee stated that ongoing problems in international credit markets and the global economy continue to restrain the aggregate demand.

Monetary Policy and Risks

12. Considering the monetary tightening since May, the Committee indicated that the level of the policy rate was supportive of disinflation. The decline in longer-term interest rates owing to easing domestic uncertainties should support domestic demand. However, aggregate demand is still expected to remain contained given relatively tight credit conditions, restrictive monetary policy, and moderating external demand.
13. The committee indicated that oil prices have followed a significantly lower course than the levels assumed in the baseline scenario in the July Inflation Report and other commodity prices have also displayed a downward course, improving the near-term inflation outlook. Consequently, inflation is expected to fall gradually in the forthcoming period.
14. Food prices have been evolving in line with the projections outlined in the July Inflation Report. It is anticipated that processed food inflation will gradually fall owing to lower commodity and import prices while unprocessed food inflation will maintain its current favorable course. Yet, the Committee underlined the need to remain cautious with regard to assumptions on food and oil prices, given the volatile course of commodity prices.
15. The Committee noted that the rise in inflation expectations was limited although inflation outturn was significantly higher than the average of market expectations in June. Inflation expectations should ease gradually as inflation starts decelerating in the forthcoming period.
16. Despite the expected decline in inflation in the medium term, uncertainties exist regarding the degree of inflation persistence. Long-lasting supply shocks have been delaying disinflation and thus increasing the risk of rising backward looking schemes in the wage and price setting behavior. Although the widening output gap should contain the second round effects of the supply shocks, the exact pace of disinflation would still depend on the extent new inflation targets serve as a strong reference for economic agents. Having this in mind, the CBT will continue to focus on enhancing the credibility of the new inflation targets.
17. International financial markets remain fragile. Prevailing problems in financial markets continue to pose downside risks on global economic growth. Persisting uncertainties in the global economy have been causing financial markets to be sensitive to data announcements. The CBT will not display a sharp reaction to temporary fluctuations in the financial markets, unless there is a long lasting deterioration in expectations and a significant worsening in the general pricing behavior.

18. Inflation and monetary policy outlook outlined above envisages that government expenditures and incomes policy will evolve in line with the official projections and that there will be no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanisms. Any deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.
19. In sum, prevailing risks regarding the price setting behavior and ongoing global uncertainties require monetary policy to remain cautious and to be more responsive to incoming data. Future decisions on policy rates will depend on developments in global markets, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.
20. Prudent monetary policy is a necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical in the road to price stability. 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 envisaged in the economic program 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 by the CBT with regard to their implications on macroeconomic and price stability.