No: 2008-11

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING
Meeting Date: April 17, 2008

Inflation Developments

1. Consumer prices rose by 0.96 percent in March, pushing annual inflation up to 9.15 percent. Inflation went up primarily due to soaring processed food prices and exchange rate movements, breaching the upper bound of the uncertainty band in March.

2. The processed food prices continued to rise sharply during the first quarter of 2008. In March, processed food prices rose by a dramatic 2.86 percent, lifting annual inflation in processed food to 16.63 percent. Annual rate of increase in bread and grain prices reached 20.14 percent. Overall, processed food prices have remained elevated, further aggravating the pressures on food inflation.

3. Energy prices were up 0.98 percent in March. The steep increase in crude oil prices and the weakening of the Turkish lira drove fuel prices higher in March, portending a further rise in April. Moreover, elevated oil prices have added to the pressures on the prices of energy utilities in housing.

4. Inflation in goods excluding energy and unprocessed food edged up slightly in March after having flattened out during the past three months, as clothing and footwear prices increased by 1.80 percent, which is above the seasonal average. The recent depreciation of the Turkish lira had a limited effect on prices of durables in March. Yet, the lagged effects of exchange rate movements are likely to put pressure on consumer durables in April.

5. Although rental inflation has decelerated further, the continued rise in energy and food prices has driven prices for transport and catering services higher, causing the annual services inflation to edge up by around 0.5 basis points to 8.93 percent in March. Annual inflation in other sub-categories of services also displayed a rise.

6. The Monetary Policy Committee (the Committee) noted that inflation may temporarily rise in the second and third quarters due to rising oil prices, lagged exchange rate pass-through and unfavorable base effects, before starting to fall again in the final quarter.

Factors Affecting Inflation

7. Gross Domestic Product (GDP) grew by 3.4 percent in the fourth quarter of 2007 in annual terms, resulting in a GDP growth of 4.5 percent for the whole year.

8. Private consumption and investment made the greatest contribution to the fourth-quarter GDP growth. Government spending, on the other hand, provided a limited contribution. Besides, the contribution of net external demand was negative at 3.7 percentage points. The Committee noted that the demand for domestic goods and services remained low during this period, as local residents had increased their demand for imported goods for their relative price advantage. In fact, the fourth-quarter GDP growth falls to 0.2 percent if stock changes are excluded.

9. In seasonally adjusted terms, GDP displayed a 2.1 percent quarterly growth in the last quarter of 2001. Yet, the Committee stated, in consideration of global uncertainties surrounding the current economic climate, that this growth provides only a partial insight into the upcoming period. Indeed, industrial production during January-February remained unchanged from the previous quarter on a seasonally adjusted basis, indicating that economic activity has continued to moderate.

10. Indicators for consumer demand confirm the slowdown in domestic demand. In seasonally adjusted terms, the first-quarter CNBC-e consumption index remained unchanged on a quarterly basis, whereas the import quantity index for consumer goods was slightly down from the preceding quarter. In the meantime, domestic sales of automobiles were markedly up in annual terms on the back of a low base effect, but were significantly lower than the figures recorded a quarter earlier. Domestic sales of white goods have declined both on a quarterly and annual basis during January-February. The Committee noted that seasonally adjusted sales of white goods have fallen below the range between 400,000 to 450,000 units, their lowest level since the first quarter of 2004.

11. Moreover, the CNBC-e and CBT consumer confidence indices have been on the fall since September, when global risks became more apparent. In fact, after a rebound during the first half of 2007, the growth of consumer loans has slowed down for the second consecutive quarter. The Committee assessed that the global credit crunch has recently continued to hold down consumer loans.

12. The fourth-quarter rebound in private sector’s machinery-equipment investment is expected to be short-lived. Indicators for the first quarter of 2008 suggest that the investment demand for imported goods is still robust, while the production of domestic capital goods has slowed from the previous quarter. Imports of capital goods, which saw a dramatic annual growth of 34.3 percent during January-February, point to a quarterly acceleration as well. However, the slowdown in machinery-equipment production for the past one year continued into the first two months of 2008, resulting in an annual decrease of 6.2 percent. Besides, electrical machinery production and domestic sales of light commercial vehicles increased annually at a fairly strong rate, but declined quarterly in seasonally adjusted terms. Sales of heavy commercial vehicles have remained low since the monetary tightening and narrowed slightly on a quarterly basis in response to the slump in March. In sum, available production,

import and sales data suggest that machinery-equipment investments will slow down in the first quarter of 2008, but will remain above their year-ago level thanks to the base effect.

13. Construction investments have flattened out for the past one and a half years. Residential construction permits declined in 2007 in annual terms. Along with the downdraft in construction activity, production gains in housing-related industries have stalled. The production of nonmetallic minerals, an intermediate input to construction activity, remained unchanged in 2007 from the previous year, while furniture manufacturing decreased by 13.8 percent. The housing sector will continue to be restrained by rising precautionary savings and tighter credit conditions due to global uncertainties.

14. In sum, recent readings on the private demand for consumption and investment have slowed down. The labor market also suggests a similar outlook. In seasonally adjusted terms, non-farm employment increased by a quarterly 0.1 percent on average during 2007, after having risen at a steady quarterly average of 1.1 percent from 2001 to end-2006.

15. The contribution of net exports to GDP growth turned negative in the second half of 2007 mainly due to rising imported goods driven by lower relative prices. Recent data indicate that the sizable annual growth in exports and imports has continued into the first quarter of 2008. Thanks to the sharp increase in export quantity during January-February, growth in real exports was stronger than imports. Given both the recent weakening of the Turkish lira and the slowdown in domestic demand, the rate of increase in import quantity will likely begin to decelerate in the second quarter and net exports will make an increased contribution to growth. Yet, the possibility that international prices of oil and other commodities might increase further continues to pose a risk to the foreign trade deficit.

16. According to export data released by the Turkish Exporters' Assembly for March and April and "expectations for export orders for the next three months" from CBT's Business Tendency Survey, exports will continue to grow sharply in the second quarter of 2008. Although the more pronounced downside risks to the growth of advanced economies might put pressure on the export performance, the increased weight of exports to countries other than EU and the US during the past few months can partially offset that risk.

17. In sum, deepening problems in international credit markets continue to restrain the domestic demand, while external demand remains strong. Overall, aggregate demand conditions continue to support disinflation.

18. After growing modestly in the second and third quarters of 2007, labor productivity in the manufacturing industry posted a recovery thanks to the relatively strong fourth-quarter production. In this sense, unit labor costs fell on an annual basis and

continued to support disinflation, though at a lesser extent. The Committee emphasized the need to implement measures to improve the investment climate and to foster productivity, which would support price stability in the medium term.

Monetary Policy and Risks

19. Rising food and energy prices and ongoing uncertainties in the global economy have worsened inflation expectations and increased the upside risks on inflation. Accordingly, monetary policy adopted a tightening bias.

20. The members also assessed the revisions in forecasts to be published in the Inflation Report. The Committee pointed that food and energy prices may continue to rise due to structural factors and this should be taken into account while revising the forecasts. Consequently, assuming a continued rise in food and energy prices and incorporating recent exchange rate movements have led to a significant upside revision in the inflation forecasts.

21. The Committee assessed that bringing inflation back to 4 percent by the end of 2009 would require offsetting the first round effects of the likely supply shocks that are expected to continue during 2008-09, and thus create undesired fluctuations in the economic activity and relative prices. In fact, revised projections suggest that, converging to the medium term target of 4 percent may extend beyond two years, even when tight monetary policy is maintained for an extended period.

22. Since inflation is seen above the medium term target for a considerable period, the meeting agenda also covered the issue of target revision. Committee members indicated that changing the target for end-2008 would not be appropriate, since doing so would be a clear violation of the accountability principle in practice. Regarding targets for 2009 and afterwards, the Committee assessed that, given the uncertainty surrounding the food and energy prices as well as the global economy, it would be wiser to reconsider the issue towards the end of this year in tandem with the budget preparations. Accordingly, we envisage a framework in which forecasts serve as intermediate anchors while the medium term is anchored by the 4 percent target. The Committee therefore noted that extending the forecast horizon in the Inflation Report to three years would enhance the efficiency of the overall strategy of monetary policy.

23. In light of these considerations, we expect inflation to reach 4 percent in three years. Extending the horizon within which inflation converges to the target does not mean that monetary policy will be looser in the forthcoming period. On the contrary, the Committee will be more responsive to bad news than good news and will consider a measured tightening when needed.

24. The Committee indicated that the revised forecasts, which are based on quite conservative assumptions--especially on food and energy prices, imply that downside risks are as significant as upside risks. Considering the significant role of supply

shocks under current conditions, it was noted that providing projections under alternative scenarios for food and energy prices would be beneficial for the communication of monetary policy. The Committee also assessed that materialization of upside risks would require further tightening of the monetary policy stance, while downward surprises in food and energy prices would be perceived as an opportunity to bring inflation back to target in a shorter period.

25. A protracted period of rising food and energy prices have led to a significant overshooting of the inflation targets since the adoption of the inflation targeting regime and consequently increased the stickiness in inflation expectations, as economic agents have become more backward looking. Under normal conditions, supply shocks are expected to alter relative prices rather than the underlying inflation trend. Nevertheless, the fact that several long-lasting shocks appeared concurrently has increased the risks to the price setting behavior. This view is also supported by a recent study by the CBT staff, which suggests that recently economic agents have been attaching more weight to past inflation in forming their expectations. Overall, it may be necessary to pursue a tighter monetary policy should the price setting behavior continue to deteriorate.

26. Another major risk to the inflation outlook is a sharper than expected slowdown in the global economic activity, which, in turn, could lead to further volatility in financial markets. The eventual impact of the financial turmoil on the global economic activity is yet to be seen. These uncertainties have been dampening the risk appetite and thus slowing the capital flows to emerging economies. The CBT will not react to temporary fluctuations in financial markets. Yet, we will not hesitate to tighten monetary policy in case of a significant worsening in the overall pricing behavior.

27. The Committee underscored that current liquidity conditions provide the CBT with a flexible tool to engineer a rapid monetary tightening when needed. The excess liquidity in the money market has been shrinking during the past few months, due to factors such as reduced daily minimum amount in reserve purchase auctions, relatively low rollover ratio of the FX debt by the Treasury, and rising money demand. This trend is expected to prevail in the forthcoming period, possibly leading to a tightening in monetary conditions. The Committee therefore noted that this framework provides the CBT with a flexible and efficient tool, which makes it possible to implement a monetary tightening without conducting a formal MPC meeting.

28. Finally, the Committee underscored that the medium-term inflation projections assume no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanism. In particular, this means that any needed tightening in the fiscal balance would occur largely through expenditure cuts rather than higher excise taxes. Any deviation from this framework may have an effect on the outlook for inflation and monetary policy.

29. In sum, the Committee assessed that preventing the potential second-round effects of the recent deterioration in inflation expectations might require maintaining a tight monetary policy for a considerable period. Future monetary policy decisions will depend on developments regarding global market conditions, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.

30. 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.