

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING**Meeting Date: 17 January 2008*****Inflation Developments***

1. Consumer prices rose by 0.22 percent in December. After this reading annual inflation ended the year 2007 at 8.39 percent. Services inflation resumed its downward trend in December thanks to favorable developments in the prices of rent and transportation services.
2. The prices of unprocessed food have stabilized, albeit partially, in the last two months of the year, leading to a reduction in the annual inflation of this sub-group. Meanwhile, despite a relative slowdown, the processed food prices continued to increase at a rapid pace. The 9.8 percent increase in processed food prices in the second half of the year adversely affected the core inflation indicators. Recent data on precipitation indicates a more favorable weather outlook compared to the previous period, boding well for the future prices of unprocessed food group. On the other hand, the response of processed food prices to agricultural supply shocks is likely to persist for some time; therefore, price increases in this group may continue for a while in 2008.
3. Energy prices rose by 0.89 percent in December due to hikes in energy items in the housing group. With these hikes, annual inflation in the energy sub-group reached to 11.25 percent. A marked rise in the annual inflation of the energy group is expected in January due to adjustment in the prices of electricity and natural gas. The aforementioned price adjustment is expected to contribute by 0.6 points to CPI inflation in January.
4. Year on year increase in the prices of goods excluding energy and unprocessed food climbed to 6.60 percent due to increase in processed food inflation and the base effect in clothing-footwear group. Meanwhile, the downward trend in the prices of consumer durables continued in December.
5. Despite a pick up in the prices of communication services, the services inflation dropped in December due to an ongoing moderation in the inflation of rents and transportation service prices. Although year-on-year inflation in restaurants and hotels group continued its upward trend, the pace of monthly price increases in food services, which constitute a substantial part of this group, slowed down compared to the last three months. Overall, inflation in services group decelerated by 3.6 percentage points in 2007 compared to the

previous year and stood at 8.64 percent. The Committee expects this downward trend in services inflation to proceed in the upcoming period.

6. A review of the year 2007 reveals that unfavorable developments in the prices of items outside the control of monetary policy such as food, energy and tobacco products were the main factors to slow down the downward trend in inflation. The Committee assessed that the annual rate of increase of the CPI excluding the aforementioned groups followed a moderate course.

Factors Affecting Inflation

7. Readings on recent data indicate that the recovery in economic activity has continued in the last quarter of 2007. Industrial production increased by 8.3 percent and 7.7 percent year-on-year in October and November, respectively, and the average of October-November period exceeded the third quarter average in seasonally adjusted terms. Seasonally adjusted figures on capacity utilization suggest that the growth in industrial production has continued in December as well.
8. Leading indicators on consumption and investment present a similar outlook. Domestic sales of automobiles increased by 36.6 percent quarter-on-quarter and picked up markedly in seasonally adjusted terms compared to the third quarter. The moderate growth in consumer loans continued in December. The month-on-month change in automobile loans was positive in real terms for the first time since June 2007. Real imports of consumer goods, passenger cars and consumer durables in particular, increased significantly on a year-on-year basis in the last quarter of 2007. The upward trend in the seasonally adjusted CNBC-e consumption index continued in the same period. The Committee will closely monitor the upcoming data to assess whether the recent pickup in the demand for durables reflects a change in trend.
9. Leading indicators for investment demand point to an increase in machinery-equipment investments on a year-on-year and per quarter basis in the last quarter. In the October-November period, imports of capital goods increased by 36.2 percent relative to the same period last year, exceeding the level recorded in the third quarter in seasonally adjusted terms. Following a rebound in the third quarter, sales of light commercial vehicles maintained the upward trend in the last quarter growing by 23.6 percent in annual terms and recording a discernible rise in seasonally adjusted terms over the third quarter. Meanwhile, sales of heavy commercial vehicles have declined continuously on a monthly basis since September 2007, but rose by 1.6 percent year-on-year in the last quarter. Moreover, seasonally adjusted figures on production and import of machinery-equipment and electrical machinery point to a pick up in investments in the last quarter.

10. In the third quarter, the number of construction permits, one of the leading indicators of construction investments, decreased by 10.8 percent on a year-on-year basis, while the annual growth rate of the construction sector significantly lagged behind the growth rates observed in previous periods. The diffusion index of “the probability of purchasing or constructing a house in the next 12-month period”, compiled from the Consumer Confidence Survey, has followed a downward trend since July 2007 suggesting that the slowdown in the growth rate of housing construction is likely to persist in 2008. Meanwhile, the significant rise in employment in the construction sector in seasonally adjusted terms during the second and third quarters of the year and a marked increase in the production of non-metallic minerals in the last quarter signal that the slowdown in construction sector would be rather modest. In view of these data, the Committee assessed that the construction sector would continue to grow, albeit at a slower pace, in the upcoming period.
11. Exports rose by 13.5 percent in real terms compared to the same period last year according to quantity indices. Early readings on December and January also point to a continued upward trend in exports. Nevertheless, the growth rate of exports was surpassed by the growth rate of imports in the fourth quarter due to recovery in domestic demand and substantial increases in imports. Therefore, the effect of net foreign demand on growth is likely to be negative in the fourth quarter. The expected slowdown in the economic activity of developed countries has increased the downside risks on the course of exports.
12. In the third quarter of 2007, the pace of productivity growth fell behind real wages in the manufacturing industry, leading to an increase in unit labor costs. Nonetheless, the slowdown in employment and the increase in productivity gains in the last quarter of the year points to a possible renewal of the downward trend in unit labor costs in the manufacturing industry.
13. Unit labor costs, which significantly contributed to the recent disinflation process as well as the export performance, will be closely monitored. In this context, implementation of structural reforms that will ensure the sustainability of productivity gains is still of utmost importance. Considering the downside risks on global economy, the Committee emphasized that the efforts to support productivity gains via structural reforms will limit possible adverse effects of recent turbulence on exports and economic growth in the medium term.
14. In summary, readings on the last quarter of 2007 suggest that the economic activity has picked up markedly compared to the third quarter. However, although indicators on demand conditions point to a higher growth than the first half of 2007, they are still below the level observed during periods of

accelerated domestic demand. Therefore, recent pick up in economic activity is considered as a gradual recovery rather than a strong acceleration.

15. To sum up, the Committee assessed that the economy continued to grow at a moderate pace. The lagged effects of monetary tightening and the weakening of global credit conditions have restrained domestic demand. Moreover, the expected slowdown in global economic activity may reduce the contribution of external demand to the economic growth in Turkey. Accordingly, aggregate demand conditions should continue to support disinflation process in the upcoming period. In this context, inflation is expected to decelerate despite the risks from food and energy prices.

Monetary Policy and Risks

16. Drought and energy related supply shocks not only increased inflation temporarily but also had short-term adverse effects on growth. The Committee underlined that the primary goal of the Central Bank is to achieve and maintain price stability. However, the CBT follows a medium term approach, and thus will not react aggressively to the shocks beyond the control of monetary policy, since doing so could create undesirable fluctuations in economic activity and distortions in relative prices. This strategy implies that the CBT, faced with persisting supply shocks, may choose to tolerate inflation to exceed the target temporarily, as long as the second round effects are contained.
17. The Committee noted that monetary policy remains restrictive even after the recent rate cuts. The modest growth rate of monetary indicators is also consistent with a relatively restrictive monetary stance. Although medium term interest rates followed a downward trend in the past quarter, 2-year real rates at this point fluctuate between 9 and 10 percent, implying a non-accommodative monetary stance. Recent developments in consumer credit also point to a similar picture. Annual growth rates in the automobile and housing loans are at much lower levels compared to the periods of vigorous domestic demand. Although consumer credit showed signs of recovery starting from the second quarter of 2007, cautious monetary policy stance and the tightening in global credit conditions are likely to restrain credit expansion in the forthcoming period.
18. Notwithstanding the expected fall in the underlying inflation, there are both upside and downside risks to the inflation outlook:
19. The main upside risk factor for the current medium term inflation outlook is a potential second round effect of the accumulated supply shocks, which may also create a higher than expected inflation inertia, as currently manifested in the medium term inflation expectations. So far, the second round impact of

food prices has been limited and confined to selected sub-components of the overall index (such as restaurants and catering services). The potential second round impact of elevated food and energy prices, however, should not be overlooked. Therefore, the CBT will keep a close eye on the price setting behavior along with various core inflation measures. The policy strategy will be to tolerate the first-round impact on inflation resulting from food, energy and one-off adjustments in administered prices, yet to remain responsive to the second round effects.

20. The Committee remains attentive to developments in global markets. The potential impact of ongoing difficulties in the US credit markets, on the financial markets and the real economy, continue to create uncertainty about the course of the global economy. Our baseline scenario assumes a soft landing in developed economies, with no major portfolio shock on the Turkish financial markets. However, the probability of a sharper than expected slowdown should not be ruled out. While the possibility of a sharper than envisaged slowdown in global economic activity, through a portfolio shock and its potential impact on the exchange rates, may constitute an *upside* risk for the short-term inflation outlook, it also poses *downside* risks for inflation in the medium term through a possible weakening in external demand and domestic credit.
21. It should be underlined that fiscal discipline of the past several years, by reducing the long-term risk premium, has been the key force allowing the achievement of robust output growth during a remarkable disinflation period. Maintaining the prudent fiscal policy, during an episode of worsening risk appetite, is even more critical in preserving the resilience of the economy.
22. 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 primarily through expenditure cuts rather than hikes in indirect taxes. Therefore we envisage no major shocks arising from administered price adjustments, except the hikes in electricity and natural gas in the first quarter of 2008. Any deviation from this assumption may alter the inflation and monetary policy outlook.
23. The recent increase in end-user energy prices may continue to exert some temporary upward pressure on headline inflation in the coming months. However, these adjustments will also support lower inflation in the medium term as they contribute to a prudent fiscal stance and facilitate an expansion of the domestic energy production. Hence the CBT's policy is not to react to these price adjustments, except to contain second-round effects.

24. Developments in food prices are still considered as an important risk to the short-term inflation outlook, as food items constitute more than one fourth of the CPI basket. The course of food inflation is highly dependent on domestic weather conditions as well as global developments. In the medium term, there is a significant chance of a downward correction in unprocessed food inflation, especially given the base effect created by the last two year's elevated food prices. On the other hand, it is also possible that global developments and increasing demand for certain food items may push the food prices up further. Therefore, food prices continue to pose risks to the inflation outlook on both sides.
25. Accordingly, monetary policy decisions in the forthcoming period will be largely dependent on new data and developments. The Committee will closely monitor the lagged impacts on the wage and price-setting behavior of the recent rate cuts, the second round effects of elevated food and energy prices, and developments in incomes policy. The timing of further easing will depend on incoming information regarding global liquidity conditions, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.
26. So far, Turkish economy has been resilient to reappraisal of risks in global financial markets. The support from fiscal policy and structural reforms are critical in shielding the economy against possible further deterioration in global sentiment. 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 enhancing quality of fiscal discipline and raising productivity are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.