No: 2013 – 37

Release Date: 30 July 2013

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 23 July 2013

Inflation Developments

1. In June, consumer prices edged up by 0.76 percent and annual inflation reached 8.30 percent. This uptick was attributed to the rise in unprocessed food prices besides the base effect in energy prices. Total contribution of price increases in food and energy groups to annual inflation increased by 1.7 percentage points in June. Meanwhile, core inflation indicators remained on a mild track.

2. On the food and non-alcoholic beverages front, annual inflation soared by 5.81 percentage points to 12.88 percent. As for the unprocessed food group, driven both by the price hikes in fresh fruits and the base effect in vegetable prices, annual inflation registered a remarkable increase. On the other hand, annual processed food inflation receded to 8.11 percent. Bread prices remained on an upward track in this group, while other processed food products maintained a mild course. Leading indicators pertaining to July point that the downward correction in unprocessed food prices has not started yet.

3. Energy inflation went up owing to the depreciation in the Turkish lira. Due to the recent increases and the base effect, annual rate of increase in energy prices is envisaged to push annual inflation up in July as it did in June. Meanwhile, the base effect is estimated to pull inflation down considerably as of August.

4. Prices of services went up by 1.19 percent, and annual services inflation increased to 7.88 percent in June. Nearly 0.5 percentage points of the rise in annual inflation was attributed to the hikes in driving course fees. Excluding this one-time effect, seasonally adjusted data suggest that the underlying trend of services inflation remained almost unchanged on a monthly basis.

5. Annual inflation in core goods group receded in all subcategories, particularly clothing, and stood at 3.28 percent in June. It is observed that the depreciation in the Turkish lira has not been evidently reflected on to prices yet; and thus the seasonally adjusted trend of core goods prices maintained its downtrend in June. Accordingly, seasonally adjusted trends of core inflation indicators remained on a mild course.

6. In sum, notwithstanding the mild course of core inflation indicators, inflation is expected to fluctuate in the short term due to the volatility in food and energy inflation, base effects and the movements in the exchange rates. Accordingly, inflation is projected to rise in July before falling significantly in August.

Factors Affecting Inflation

7. Second-quarter data point that domestic demand follows a healthy recovery in line with expectations. Industrial production posted an increase in April-May period compared to the first-quarter average. Industrial production is envisaged to register a month-on-month increase in June as well. Improved consumer confidence in April and May underpinned the rise in domestic demand. Despite the slight decline in confidence indices in June, consumption demand is expected to pick up on a quarterly basis in the second quarter. In fact, sales of automobiles and credit growth maintained a robust trend of increase in this period. Although displaying a favorable outlook, indicators of investment demand point to a weaker growth compared to the consumption demand.

8. Data regarding the second quarter foreign trade and the current account balance are in line with expectations. Import demand revives upon the recovery in the domestic demand, while exports grow at a moderate pace. Annual cumulative foreign trade and current account deficit figures in the short term are expected to continue with an upward trend mainly due to gold imports. On the other hand, the current policy framework, which puts special emphasis on macro-financial risks, limits the deterioration in the current account balance. Accordingly, current account deficit, excluding gold trade, has been on a stable course.

9. Non-farm employment remained on a steadily increasing track in April 2013. Nevertheless, seasonally adjusted unemployment rate remained unchanged upon the rise in employment participation rate. While the recent rise in non-farm employment was mainly driven by the industrial sector besides the construction sector, service sector employment remained flat. The PMI data signal that industrial employment will continue to increase, albeit at a decelerating pace. Yet, uncertainty regarding the global economy remains as risk factor that may restrain investment and employment growth in the forthcoming period.

Monetary Policy and Risks

10. The meeting included an assessment of the impact of the recent developments in capital flows, which have weakened since May due to increasing uncertainty regarding the global monetary policies. The Committee observed that loan growth

continues to hover above the reference rate despite the slowdown in capital flows, indicating that tightening the monetary policy stance under these circumstances would support financial stability.

11. The Committee also assessed the medium term projections prepared for the July Inflation Report. It was stated that several coinciding developments have recently affected inflation expectations adversely. Surging unprocessed food prices, rising oil prices, and the increased exchange rate volatility may continue to have adverse impact on inflation in the short term. Overall, given the assumptions underlying the inflation forecasts and external conditions, end-2013 inflation forecast was revised upwards mainly on account of the developments in the exchange rate and oil prices. These developments are expected to have a limited effect on end-2014 inflation due to the weak outlook of the global economy and the mild course of domestic demand. Yet, the Committee indicated that a measured monetary tightening is deemed necessary in order to contain a deterioration in the pricing behavior.

12. In order to support the price and financial stability, the Committee decided to raise the upper bound of the interest rate corridor. It was underscored that cautious stance will be maintained until the inflation outlook is in line with the medium term targets. In this respect, additional monetary tightening will be implemented when necessary.

13. Currently, data regarding global economic activity do not reveal a stable pattern. Risk appetite and capital flows may remain volatile, should uncertainties regarding economic policies of advanced economies persist. This situation may pose risks regarding the outlook for inflation and financial stability. Materialization of such a risk will prompt the Central Bank to use the interest corridor and other policy instruments to contain the excessive volatility in the exchange rate.

14. On the other hand, the possibility of further delays in the global recovery and the continuation of quantitative easing policies for an extended period by the central banks of advanced economies remain as downside risks, in which case capital flows to emerging economies may re-accelerate. Materialization of such a scenario would prompt the Central Bank to engage in a strategy in which short-term money market rates are lowered by easing liquidity conditions, while the adverse impact of rapid capital inflows on financial stability is alleviated through reserve requirement policy and reserve options mechanism.

15. Due to ongoing uncertainties regarding the global economy and the volatility in capital flows, the Committee decided to increase the flexibility of the liquidity management. To this end, developments regarding price stability and financial

stability will be closely monitored and necessary adjustments will be made in the composition of Turkish lira liquidity provided by the Central Bank.

16. The Committee monitors fiscal policy developments and tax adjustments closely with regard to their effects on the inflation outlook. The baseline monetary policy stance takes the fiscal framework outlined in the Medium Term Program as given. In this respect, it is assumed that fiscal discipline will be sustained and there will be no unanticipated hikes in administered prices. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework and consequently have an adverse effect on the medium-term inflation outlook.

17. Prudent fiscal and financial sector policies are crucial for preserving the resilience of our economy against existing global imbalances. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the savings deficit would support macroeconomic stability in the medium-term. This will also provide more flexibility for monetary policy and improve social welfare by keeping interest rates of long-term government securities persistently at low levels. In this respect, implementation of the structural reforms envisaged by the Medium Term Program remains to be of utmost importance.