

## SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 18 September 2012

### *Inflation Developments*

1. In August, consumer prices were up by 0.56 percent, while annual inflation decreased to 8.88 percent mainly owing to core goods prices. In this period, the underlying trend of core goods inflation maintained its downward course upon the alleviation of cost and demand-side pressures, while the services inflation maintained its moderate course.
2. On the food and beverages front, annual inflation remained flat with 9.14 percent. As for the unprocessed and processed food groups, annual inflation increased in the former, and decreased in the latter. Seasonally adjusted unprocessed food prices recorded an increase in August as they did in July. In this period, not only the prices of fruits and vegetables, but also meat and milk prices went up. Leading indicators suggest that the rise in unprocessed food prices has continued in September as well due to the price developments in fresh fruits and vegetables. On the processed food front, bread and cereals saw price hikes. However, the annual rate of increase in processed food prices declined in August owing to the relatively mild course in other processed food prices. Despite the halt in the trend of price increases in international markets, the high level of wheat prices poses a risk on processed food prices; yet it is projected that the deceleration in processed food inflation will continue in the forthcoming period.
3. Amid the developments in oil prices, energy prices soared by 2.29 percent in August parallel to the rise in fuel and bottled gas prices. On the services front, annual inflation has remained flat as it did in the last three months. Annual inflation declined in transport services, but increased in rents in this period. Seasonally adjusted price and diffusion indices point that the underlying trend of the prices of services maintained its mild course.
4. As for the core goods group, annual inflation decreased by 0.7 percentage points to 7.41 percent. This decline prevailed among all subcategories of core goods. Particularly, the cumulative increase in durable consumption goods prices since the beginning of the year has remained limited, which is worth noting.

5. Against this background, the Monetary Policy Committee (the Committee) assessed that the decline in inflation might be subject to a temporary halt in September; but the downward trend in inflation will resume afterwards at a faster pace. As for the core inflation, a gradual decline is foreseen to continue.

### ***Factors Affecting Inflation***

6. Economic activity posted a remarkable increase in the second quarter of 2012 compared to the previous quarter in consistency with the outlook presented with the July Inflation Report. Meanwhile, the Committee underlined that this increase was mainly driven by the compensation of temporary factors like adverse weather conditions that decelerated the economic activity; and therefore the trend in economic activity manifested itself as a mild growth. Moreover, it was reiterated that the increased contribution of net external demand to growth reflects the impact of the policies implemented since late 2010 on the rebalancing process.
7. Final domestic demand has continued with a modest pace in the third quarter. Production and imports of consumption goods in July went above the average of the previous quarter. Automobile sales and consumption indices pointed to increases, while sales of white goods posted a decline. Machinery-equipment production and sales of heavy commercial vehicles exhibited a weaker outlook in investment demand compared to consumption.
8. Production indicators confirm the mild outlook in the economic activity. Seasonally-adjusted industrial production in July has largely compensated for the decline in June. Three-month ahead expectations for orders of the manufacturing industry firms increased in August as they did in July, while the capacity utilization rate remained flat. On the other hand, the Committee stated that the deceleration in consumer and investor confidence and the investment tendency data posed a downside risk on the economic activity.
9. The rebalancing between the domestic and external demand continues as envisaged. Imports have recorded a decline amid the mild credit growth and relative price movements, while exports continue to increase despite the weakening global outlook. Overall, 12-month cumulative current account deficit continues to improve gradually.
10. In June, unemployment rate went down on account of the rise in non-farm employment. Non-farm employment rise was driven by services and construction sectors, while industrial employment remained flat in this period. Leading indicators for industrial employment signal for a deceleration in the pace of employment rate in the third quarter. Other indicators of the labor market suggest a slight slowdown in the pace of employment in the July-August period. The Committee assessed that parallel to the moderate increase in economic activity, the rise in employment would also follow a mild course. Furthermore,

uncertainties regarding the global economy remain to be critical factors that may restrain investment and employment growth in the period ahead.

### ***Monetary Policy and Risks***

11. In light of these developments, the Committee indicated that aggregate demand conditions support disinflation. Moreover, easing cost pressures, as observed in the moderate course of manufacturing prices, have been contributing positively to the core inflation dynamics. Accordingly, also taking account the base effects from the previous year, the fall in inflation is expected to become more evident during the last quarter of the year. Yet, the Committee underscored that, given the recent increases in energy prices and given that inflation will continue to stay above the target for some time, a cautious stance regarding pricing behavior is warranted.
12. The Committee indicated that the scenario presented in the Inflation Report on “additional monetary easing by the central banks of developed economies” has been partly realized. In fact, recent developments have led to an improvement in the risk appetite in global financial markets. The Committee stated that this development has the potential to lead to an acceleration of capital inflows. Therefore, increasing the reserve option coefficients and narrowing the interest rate corridor would support financial stability. Moreover, it was indicated that a measured step in the same direction may be taken in the forthcoming period, if deemed necessary.
13. In terms of smoothing the volatility in domestic markets caused by the capital flows, reserve option mechanism reduces the need for the interest rate corridor. On the other hand, the Committee reminded that interest rate corridor has other functions both for the transmission of credit channel and for efficient liquidity management. Therefore, it was stated that interest rate corridor will be continue to be used as an active policy instrument.
14. Although the risk appetite has improved in financial markets due to recent developments, ongoing uncertainties regarding the global economy necessitate the monetary policy to remain flexible on both sides. Therefore, the impact of the measures undertaken on credit, domestic demand, and inflation expectations will be monitored closely and the funding amount will be adjusted in either direction, as needed.
15. The Committee monitors fiscal policy developments closely while formulating monetary policy. Current monetary policy stance is based on the assumption that fiscal discipline will be maintained and the adjustments in administered prices will be consistent with inflation targets. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework and have a consequent adverse effect on the medium-term inflation outlook.

16. Maintaining the prudent fiscal policy implemented in recent years is crucial for preserving the resilience of our economy against existing global uncertainties. Continuing the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the saving deficit, would support the relative improvement of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium term. This will also provide more flexibility for monetary policy and contribute to social welfare by keeping interest rates of long-term government securities at low levels. In this respect, steps towards implementation of the structural reforms envisaged by the Medium Term Program remain to be of utmost importance.