No: 2011 – 16

1 June 2011

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: May 25, 2011

Inflation Developments

1. In April, consumer prices increased by 0.87 percent, and annual inflation rose to 4.26 percent. This increase in annual inflation reflects the lagged effects of import prices and the base effect from communication services. Therefore, core inflation indicators remained on the rise as expected.

2. Unprocessed food prices continued to support disinflation in April. Annual unprocessed food inflation fell to -0.83 percent in April from as high as 31.28 percent in October 2010. Meanwhile, annual processed food inflation remained flat. Thus, annual food inflation continued to fall in April, hitting an all-time low of 2.83 percent. However, rising fruit prices and base effects may put significant upward pressure on May's food inflation.

3. Energy prices continued to rise amid high international oil prices, bringing annual energy inflation up to 7.79 percent. Cumulative increases in oil prices are expected to pass-through other energy items over the second half of this year.

4. Services inflation remained moderate in April. Yet, as stated in the monthly price bulletin for March, annual services inflation increased due to base effects from communication services. Transport prices continued to rise slightly amid higher fuel prices, while the annual rate of increase in restaurants and hotels declined further, by a total of 2.5 percentage points in the first four months. Thus, services inflation continued to slow in seasonally adjusted terms.

5. Annual core goods (excluding food, energy, alcoholic beverages, tobacco and gold) inflation continues to surge on rising prices of imported goods. Among durable goods, prices of white goods increased at a slower rate, whereas furniture and automobile prices rose sharply.

Factors Affecting Inflation

6. Recent data releases on economic activity are consistent with the outlook presented in the Inflation Report. Despite slowing quarter-on-quarter, industrial production remained robust in the first quarter of 2011. Recent capacity and production indicators also point to a slowdown in second-quarter economic activity.

7. Private consumption and investment growth rates are moderating after a strong rebound in 2010. Production and imports data for consumption and investment goods confirm the first quarter's strong domestic demand. However, leading indicators for the second quarter such as domestic sales of automobiles, commercial vehicles and white goods as well as consumption indices are down quarter-on-quarter. Moreover, expectations for domestic orders also signal a slowdown in domestic demand.

8. External demand outlook remains weak. While the first quarter's non-gold export quantity index was slightly lower than the fourth-quarter average, leading indicators point to a moderate recovery in exports for the second quarter. Consideringthe recently mounting uncertainty about the global economy, the Committee has emphasized that downside risks to external demand remain. In this regard, the Committee has reiterated that exports would recover slowly and gradually.

9. Employment conditions continue to improve and unemployment rates are approaching the pre-crisis levels. Employment grew at a stronger-than-expected pace in the first quarter. Leading indicators suggest that this uptrend would continue in the short term, albeit at a slower rate. The Committee has stated that the improved employment conditions support domestic demand, but have yet to exert upward pressure on unit labor costs.

Monetary Policy and the Risks

10. The Committee members drew attention to capacity utilization rates in the manufacturing industry which have remained at low levels and stated that total demand outlook has not reached levels to put upward pressure on inflation. Benign course of services inflation supports the case against overheating. However, owing to the lagged impact of cumulative rising import prices, moderate increase in core inflation is expected to continue over the short term.

11. The Committee members reiterated that last year’s sharp fluctuations in food prices will lead to a volatility in headline inflation in the period ahead. In this respect, the Committee noted that inflation may exceed the year-end target of 5.5 percent in May due to base effects arising from unprocessed food prices,

and follow a volatile course thereafter in line with the path presented in the Inflation Report.

12. The effects of the tightening measures on credit growth and domestic demand have become visible in the second quarter. Recent data suggest that the pace of credit growth has been moderating. Moreover, non-energy imports, which displayed a strong print in the first quarter, are expected to follow a more benign path starting with the second quarter. Moreover, orders and sales data along with confidence indicators also signal some slowdown in domestic demand growth.

13. Despite the slowdown in domestic demand growth, developments in external demand and energy prices since the beginning of the year have been postponing the improvement in the current account. Political uncertainties in the North Africa have not only led to higher import bill through elevated energy prices,but also restrained the recovery in exports. Moreover, heightened concerns regarding debt sustainability in some euro area countries have increased the downside risks for the European economy—our major trading partner. Overall, the Committee indicated that both elevated levels of energy and other commodity prices and a weaker external demand outlook postpone the improvement in the current account balance to the last quarter.

14. In light of these assessments, considering the uncertainty regarding the global economy, the Committee has indicated that it would be useful to continue to observe the lagged impacts of the measures taken so far.

15. According to the Committee members, it would be appropriate to remain flexible regarding the exact content of the policy mix, given the high level of uncertainty arising from the global economic conditions. In this respect, it was stated that the risk scenarios outlined in the Inflation Report continue to be relevant. Therefore, in order to contain the risks towards price stability and financial stability, the Committee has decided to monitor the tightening impact of the existing policy mix and take additional measures along the same lines, if needed.

16. The meeting also included an evaluation of the course of capital inflows and foreign exchange purchase auctions. The Committee members highlighted the relative weakness in capital flows to emerging markets due to heightened concerns regarding debt sustainability problems in some euroarea countries, and stated that it might be useful to revise the amount purchased via daily auctions. It was indicated that the auction amount could be reduced gradually should the weakening in capital flows persist, which, in turn, could ease the need for further hikes in reserve requirements by reducing the liquidity injected to the market through foreign exchange purchases. Similarly, measures to be taken in the forthcoming period by other institutions in collaboration with the

Central Bank of Turkey (CBT) would also reduce the need for additional hikes in reserve requirement ratios.

17. The CBT will continue to monitor fiscal policy developments closely while formulating monetary policy. Increasing government saving—thus sustaining fiscal discipline—under current circumstances is essential to control the current account deficit driven by the disparity between domestic and external demand. Therefore saving the extra tax revenues driven by the stronger-than-expected economic activity would not only reduce financial stability risks, but also increase the efficiency of the new policy mix.

18. Monetary policy will continue to focus on price stability while preserving financial stability as a supplementary objective. To this end, the impact of the macroprudential measures taken by the CBT and other institutions on the inflation outlook will be assessed carefully. Strengthening the commitment to fiscal discipline and the structural reform agenda in the medium term would support the improvement of Turkey's sovereign risk, and thus facilitate macroeconomic and price stability. Sustaining the fiscal discipline will also provide more flexibility for monetary policy and support the social welfare by keeping interest rates permanently at low levels. In this respect, timely implementation of the structural reforms envisaged by the Medium Term Program and the European Union accession process remains to be of utmost importance.