

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: September 20, 2011

Inflation Developments

1. In August, consumer prices increased by 0.73 percent, and annual inflation went up to 6.65 percent. Due to exchange rate pass-through on core goods prices, core inflation indicators increased as well. Meanwhile, prices of services maintained their benign course.
2. Annual inflation in food and non-alcoholic beverages group dropped to 6 percent. While unprocessed food prices went up amid the surge in vegetable and meat prices, the annual group inflation went down to 2.98 percent due to the base effect. In the processed food front, price hikes across sub-groups persisted, mainly in bread and cereals besides fats and oils group. Thus, annual processed food inflation maintained its recent uptrend climbing to 8.59 percent.
3. Prices of services edged up by 0.39 percent in August, while annual services inflation increased to 5.68 percent. The surge in transport prices persisted amid soaring fuel prices. The rise in processed food prices continued to affect the prices of catering services. Mild increases in rents continued. As a result, the impact of exchange rate movements on prices of services remained limited to transport services and no significant change was seen in the underlying trend of the group's prices.
4. Annual core goods inflation rose to 6.76 percent owing to the pass-through effect from the depreciation of the Turkish lira. This rise was particularly driven by the developments in prices of durable goods such as automobile and furniture. Annual inflation in clothing group maintained its rising trend. Meanwhile, due to the protective measures taken for imports of textiles and apparel, clothing prices are expected to accelerate in the last quarter of the year.

Factors Affecting Inflation

5. Second quarter national accounts data offered a more favorable outlook than the one presented in the July Inflation Report. Quarter-on-quarter economic activity lost momentum as envisaged; however, domestic demand recorded a less-than-expected deceleration. Meanwhile, due to the plunge in imports, the

contribution of net exports to quarterly growth turned out to be positive as envisaged.

6. Recent data releases suggest that there will be a notable reduction in economic growth in the second half of the year. Having contracted for five consecutive months, industrial production in seasonally adjusted figures recovered in July. The Committee noted that this increase in July did not reflect the trends of the recent period marked by intensifying global problems. Indeed, leading indicators for production and orders point that the slowdown in economic activity will become more pronounced as of August. The persisting decline in the capacity utilization rate in the July-August period compared to the second quarter average indicates that the slowdown in the activity of manufacturing industry continues.
7. External demand remains weak. The downward revision of growth forecasts for the US and the euro area points to a deteriorating outlook for the global economy. Referring to the mounting uncertainties over growth in the world economy, the Committee noted that despite the competitiveness gains due to the exchange rate movements, global problems would continue to restrain external demand.
8. Final domestic demand continues to slow down. Due to the depreciation in the Turkish lira, the demand for durable goods, particularly automobile sales, is expected to continue to weaken. The weak course of consumer confidence supports this outlook. Declining capacity utilization rates and escalating uncertainty for demand pose a downside risk on investments. All these developments signal that the slowdown in domestic demand will continue.
9. Seasonally-adjusted unemployment rates, which went up due to the deceleration in employment in May, remained flat in June. During this period, employment posted an increase in services and construction sectors, but decreased in the industrial sector in line with expectations. Leading indicators show that this slowdown in industrial employment will continue.

Monetary Policy and Risks

10. The Committee has noted that core inflation may continue to rise in the short-term. It was indicated that the pass-through from exchange rates to domestic prices would be observed especially in core goods prices. The Committee stated that, although headline inflation will fall in September owing to the base effect from unprocessed food prices, it may exceed the target significantly at the end of the year due to the pass-through effect. However, due to the slowdown in economic activity, it is expected that the second round effects of exchange rate movements would be limited, and thus the increase in inflation would be temporary. Accordingly, the Committee has indicated that inflation outlook for the end of 2012 is consistent with the 5 percent target.

11. The deceleration in credit growth and domestic demand combined with the exchange rate movements have been contributing to the rebalancing of domestic and external demand. Third quarter data suggest that components of the aggregate demand evolve in the desired direction. Domestic demand continues to decelerate and there is notable slowdown in imports. Accordingly, the Committee expects a significant improvement in the current account balance in the forthcoming period. However, the Committee members have also highlighted the important role of structural measures that would increase the productivity and the saving rate, in order to stabilize the current account deficit at reasonable levels in the medium to long term.
12. Recently, both the worsening outlook for global economic activity and rapidly increasing concerns on the debt sustainability in Europe has led to a sharp deterioration in the risk appetite. Given the uncertainties regarding the global economy, it is now more important to monitor all developments closely, and to take the required policy measures in a timely manner. Therefore, the Committee has also reiterated that all policy instruments may be eased should global economic problems further intensify and the slowdown in domestic economic activity becomes more pronounced. The Committee members reminded that the measures taken at the August 4, 2011 interim meeting has laid out the ground for a timely, controlled and effective provision of liquidity to the market in case of a possible financial turmoil that may be triggered by global developments. In this respect, it was stated that developments would be monitored very closely and additional measures may be taken before the regular meeting, if deemed necessary. Moreover, with reference to the risk scenarios outlined in the Inflation Report, the Committee, has also reiterated that all policy instruments may be eased should global economic problems further intensify and the slowdown in domestic economic activity becomes more pronounced.
13. 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 Central Bank 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 relative 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. Therefore, addressing these issues in the new Medium Term Program and progressing with the structural reforms envisaged by the European Union acquiscommunitaire remains of utmost importance.