**No: 2010 – 27**

**31 August 2010**

**SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING**

Meeting Date: August 19, 2010

***Inflation Developments***

1. Consumer prices decreased by 0.48 percent in July and annual inflation declined by 0.79 percentage points to 7.58 percent. The fall in annual inflation was largely due to the base effects from the tax hikes on tobacco and durable goods a year ago, as noted in the July summary of the Monetary Policy Committee (the Committee) Meeting. Annual services and core goods inflation continued to moderate and core inflation indicators remained in line with medium-term targets.

2. Unprocessed food prices continued to fall in July, albeit at a slower pace than in the past two months, and annual food inflation declined to 5.52 percent. The changes in food prices were mainly attributable to the seasonal drop in vegetable prices, while meat prices were back on the rise after a two-month break. Accordingly, the contribution of meat prices to annual inflation increased to 1.6 percentage points. Observations for August suggest that the annual rate of increase in unprocessed food prices may accelerate because of higher fruit prices. The lowering of customs duties on imported livestock is expected to contain the unprocessed food inflation over the remainder of the year.

3. Annual services inflation continues to trend downwards. In seasonally adjusted terms, inflation across all services categories is seen to be slowing down. The favorable developments in food and energy prices ease the cost pressures on services prices. The annual rate of increase in services prices, excluding the relatively more demand-sensitive catering and transport services, dropped to 3.46 percent, an all-time low since the inception of the CPI.

4. Energy prices remained flat in July. Fuel prices remained broadly unchanged in line with international oil prices, while solid fuel prices continued to rise, albeit more slowly. The annual rate of increase in energy prices is expected to fall in coming months due to base effects.

5. The year-on-year rate of increase in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) slowed to 3.74 percent owing to the base effects from last year's tax cuts on durable goods. Moreover, the

tax-adjusted annual rate of increase in core goods prices remained unchanged at 2.4 percent.

6. The Committee has noted that the recent increase in international wheat and cotton prices would have implications for consumer prices, particularly for food prices and the clothing industry, respectively. In fact, annual inflation in clothing prices has been on an uptrend recently. On the other hand, in view of domestic wheat production estimates and available domestic stocks, the Committee expects that rising international wheat prices would have a limited impact on inflation.

7. On balance, the Committee has reiterated that inflation would increase temporarily in the short term before reverting back to a declining path by the last quarter of the year.

### *Factors Affecting Inflation*

8. Recent data suggest that the recovery in economic activity has slowed down. With the waning recovery, industrial production fell by 2.1 percentage points month-on-month in June, which is the deepest monthly contraction since April 2009. The Committee has emphasized that the contraction has been more pronounced in manufacturing industries which are sensitive to foreign demand.

9. July’s survey indicators show an ongoing decline in industrial orders expectations. Despite having increased month-on-month in July, capacity utilization rates continue to hover around low levels. Therefore, the Committee has concluded that the June drop in production is temporary, but that downside risks regarding the pace of recovery remain.

10. Domestic demand displays a relatively stable outlook. Second-quarter data on production and imports indicate that private consumption demand slowed quarter-on-quarter. The recent flattening of July’s survey indicators and consumer confidence indices shows that there has not been a surge in consumer spending as of the early part of the third quarter. Yet, the Committee has noted that the May-July data largely reflect the effects of the euro area debt crisis, and therefore the slowdown in domestic demand may be transitory. In fact, the steady increase in consumer loans during July shows that monetary conditions remain accommodative.

11. Investment demand continues to recover, but remains below pre-crisis levels. The production of capital goods excluding vehicles and the imports of capital goods continue to grow. Production and imports data suggest that private investments would increase significantly year-on-year during the second

quarter of 2010. Yet, the Committee has stated that the recently increased uncertainty about the pace of recovery in foreign demand might dampen new investments, particularly in the manufacturing industry.

12. There are signs of a moderate slowdown in foreign demand. The Committee, in its previous meeting, had emphasized the potential impacts of the adverse developments across key export destinations on economic activity. In fact, the export quantity index excluding gold declined markedly in June following a rise for four consecutive months. Recent foreign trade data suggest that exports remained relatively weak in July and August. Moreover, survey indicators of manufacturing industry do not indicate a significant acceleration in export orders. Therefore, the Committee expects that it would take a while before industrial capacity utilization rates return to their pre-crisis levels.

13. Although employment conditions continue to improve, unemployment rates remain at elevated levels. Seasonally adjusted data indicate that non-farm employment continued to recover in May, albeit more slowly. The employment recovery was primarily driven by the industrial sector, while employment growth in services slowed down. The Committee has noted that the weaker foreign demand conditions could dampen the labor market and thus the recovery in domestic demand in coming months. In this respect, the Committee has reiterated that the unemployment rates would continue to remain at higher levels compared to pre-crisis period for sometime, containing the unit labor costs.

***Monetary Policy and Risks***

14. The Committee has assessed that recent data releases are in line with the outlook presented in the July Inflation Report. Although domestic demand has slowed down moderately since April owing to the problems in the euro area, it is expected that domestic demand would continue to display a relatively stable outlook bolstered by the supportive monetary conditions. Recent credit surveys on the second quarter suggest that demand for both consumer and commercial loans has continued to increase. Moreover, ongoing deposit growth and improving conditions regarding banks' access to external credit are supportive for credit expansion.

15. The Committee has restated that inflation would increase temporarily in the near term before reverting to a declining path starting from the last quarter of the year. Inflation is expected to display a significant rise in August due to sharp increases in fruit prices, but then trend downwards in the last quarter with the support of a reversal in last year's food price base effects. Core

inflation indicators are expected to remain consistent with the medium-term targets.

16. In light of these developments, the Committee reiterated that it would be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period.

17. Risks regarding the global economy remain. Data releases on global economic activity have increased the uncertainties regarding the pace of the recovery. Ongoing problems in credit, real estate and labor markets across developed economies, with concerns regarding the sustainability of public debt decreasing the room for countercyclical policy are key factors underpinning the downside risks regarding global economic activity. The Committee members have stated that, should problems in the global economy further intensify, thereby increasing the possibility of a domestic recession, a new easing cycle may be considered.

18. The Committee has assessed that conditions are appropriate to gradually implement the measures outlined in the exit strategy as envisaged. However, there are risks that could necessitate bringing forward or delaying the measures outlined in the exit strategy. Recently, strengthening perceptions that developed economies will keep their policy rates at low levels for a long period, together with ample liquidity conditions have led to a surge in capital flows toward emerging markets. Given the relative improvement in the creditworthiness of Turkey during the post-crisis period, it is possible that capital inflows may further increase in the forthcoming period. Such a development would exacerbate the divergence between the pace of recovery in the domestic demand and external demand. If this pattern of growth coexists with rapid credit expansion and a deterioration in the current account balance, consequently leading to financial stability concerns, it would be necessary to utilize other policy instruments such as reserve requirement ratios and liquidity tools more effectively. Accordingly, the Committee may bring forward the measures outlined in the exit strategy that were envisaged to be implemented by end-2010. By contrast, should the uncertainties regarding global economy intensify and consequently dampen domestic demand, these measures may be implemented at a later period.

19. The Committee has indicated that recent volatility in commodity prices pose risks regarding short-term inflation forecasts. Although ongoing uncertainties regarding the global economy continue to suppress energy and industrial metal prices, climate conditions are having an adverse impact on agricultural commodities. In fact, recently, the prices of wheat and cotton, which are important inputs for core consumer goods, have displayed rapid increases. At this stage, the Committee does not view these developments as a threat

toward attaining the medium-term targets, but acknowledges the need to monitor commodity prices closely.

20. The Central Bank monitors fiscal policy developments closely while formulating monetary policy. The Committee members have indicated that the delay in the enactment of the fiscal rule has increased the importance of current fiscal policy implementation. Budget realizations in the first half of 2010 suggest that the better-than-expected performance in budget revenues, due to stronger economic activity than envisaged in the Medium Term Program (MTP), is largely being used to reduce government debt. Sustaining fiscal discipline in the period ahead as well is crucial, both in terms of providing more flexibility regarding the conduct of countercyclical monetary policy, and also for keeping the market interest rates at low levels permanently. In this respect, the Committee will continue to monitor the fiscal developments and their impact on inflation outlook closely. Should fiscal discipline be implemented through institutional and structural improvements, rather than indirect tax hikes, it would be possible to keep policy rates at single-digit levels over the medium-term.

21. Monetary policy will continue to focus on price stability in the period ahead. Strengthening the commitment to fiscal discipline and the structural reform agenda would support the improvement of Turkey's sovereign risk, and thus facilitate macroeconomic and price stability. In this respect, timely implementation of the structural reforms envisaged by the MTP and the European Union accession process remains to be of utmost importance.