

## SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: August 16, 2012

### *Inflation Developments*

1. In July, consumer prices were down 0.23 percent, while annual inflation increased to 9.07 percent mainly owing to the rise in unprocessed food prices. In this period, the underlying trend of core goods inflation maintained its downward course upon the alleviation of cost-side pressures, while the services inflation remained moderate.
2. On the food and beverages front, annual inflation reached 9.06 percent. This is attributed to the rise in seasonally adjusted unprocessed food prices as well as the base effect of fresh fruits and vegetables. Processed food prices increased principally due to the prices of bread and cereals, while the group's annual inflation went down in July. The recent increase in international agricultural prices, chiefly in wheat, constitutes an upside risk on processed food prices for the rest of the year.
3. Energy prices continued to fall in July as they did in the last two months. Nevertheless, international oil prices, which have recently trended upwards, led energy prices to increase in August.
4. On the services front, annual inflation has remained unchanged for the last three months. Annual inflation increased in transport services, while it edged down in restaurants and hotels group in July. Seasonally adjusted indicators and the diffusion index data indicate a slight slowdown in the underlying trend of the services inflation.
5. As for the core goods group, annual inflation increased slightly to 8.11 percent. While annual inflation in durable goods maintained its downward trend, other core good items posted increases in this period. However, seasonally adjusted data suggest that the deceleration in the underlying trend of core goods inflation continues. Furthermore, in this period, all diffusion indices have exhibited a downward movement. Against this background, the downward movement in the underlying trend of core inflation indicators has been sustained.

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

6. National accounts data for the second quarter of 2012 suggest that domestic demand and economic activity displayed a mild increase. This period witnessed a rise in the domestic sales of automobiles and commercial vehicles, and a modest growth in loans. Despite the decline in June, the industrial production index posted a quarterly increase upon the rises in the April-May period.
7. Recent data releases point that the economic activity keeps mild growth trend in the third quarter. Three-month ahead expectations for orders of the manufacturing industry firms edged up in July, and the downward trend in the capacity utilization rate, which has been persistent since March, came to a halt. On the other hand, domestic sales, confidence indices and the investment tendency data in the manufacturing industry point out the risk of a weaker-than-envisaged recovery in the economic activity during the third quarter.
8. Despite global economic problems, exports excluding gold have displayed a stronger upward trend since the second half of 2011. The Monetary Policy Committee (the Committee) stated that this could be attributed to the cumulative effects of rebalancing policies besides market and product diversification in foreign markets. On the other hand, imports have recorded an annual decline amid the deceleration in credit growth and the relative price movements. Accordingly, 12-month cumulative current account deficit continues to narrow down gradually.
9. The mild recovery in the economic activity is reflected on the non-farm employment rate as well. Despite the increase in employment in May, non-farm employment rate followed a flat course upon the rise in employment participation rate. Industrial employment, which has recently increased, edged down in May. On the other hand, with the support of construction and services sectors, non-farm employment recorded an increase. Although leading indicators signal for a mild deceleration in industrial employment in the short term, job vacancy data do not display an unfavorable outlook. Furthermore, ongoing downside risks on the global economy remain to be critical factors to restrain investment and employment growth in the period ahead.

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

10. Recent data confirm that the rebalancing between the domestic and external demand continues as envisaged. Domestic demand displays a modest recovery, while exports continue to grow despite the weakening global growth outlook. Overall, aggregate demand conditions support disinflation and current account balance continues to improve gradually.

11. The Committee expects inflation to follow a downward course in the forthcoming period as indicated in July Inflation Report. Core inflation indicators are also expected to follow a downward trend. Although, aggregate demand conditions contain the second round effects, pricing behavior should be closely monitored as inflation will continue to stay above the target for some time.
12. In order to support financial stability, the Committee has approved an additional increase in the allowance to hold Turkish lira reserve requirements in foreign currency and gold. Accordingly, the upper limit for the fraction of FX and gold reserves that can be held to fulfill Turkish lira reserve requirements has been raised by 5 percentage points to 60 and 30 percent, respectively. The coefficient regarding the option to hold FX or gold (reserve option coefficient-ROC) for each additional 5 percent tranche was set as “2”. Moreover, the ROC for FX for the first tranche was increased by 0.1 percentage points to 1.1. The Committee has reiterated that this mechanism aims to contain the adverse effects of the excessive volatility in capital flows on domestic markets. It was indicated that the coefficients may be revised accordingly, as needed.
13. In light of these developments, the Committee has indicated that interest rate corridor may be narrowed gradually in the forthcoming period.
14. The Committee has indicated that uncertainties regarding global economy persist. The perception that leading central banks will keep interest rates at low levels for a prolonged period encourages the search for yield. On the other hand, despite the steps taken for the resolution of problems regarding the Euro Area, risk appetite remains highly sensitive to news due to ongoing fragilities in the financial system, elevated levels of sovereign borrowing costs, and weakening growth outlook. The Committee has stated that, given the prevailing uncertainties regarding the global economy, it would be appropriate to preserve the flexibility of the monetary policy 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 stated that a further weakening in global economic outlook may prompt central banks of developed economies to implement additional monetary easing. Such an event would feed into macro financial risks for emerging economies like Turkey. A resurgence in short-term capital inflows may slowdown the rebalancing process through rapid credit growth and appreciation pressures on domestic currency. Should such a risk materialize, the Central Bank may keep short-term rates at low levels while tightening via reserve requirements and may actively utilize the mechanism it has developed for reserve requirements through an increase in ROC.

16. Another risk for the forthcoming period is the uncertainty regarding the commodity prices. Although weak global outlook dampens the upside pressures on commodity prices, prevailing geopolitical and supply-side problems pose upside risks regarding energy prices in the short term. Moreover, the recent rapid increase in agricultural commodity prices pose risks regarding processed food prices. Should such risks materialize, the Committee will not respond to temporary price movements, yet will not tolerate any permanent deterioration in expectations and pricing behavior.
17. Unprocessed food prices pose downside risks for the inflation outlook in 2012, as indicated in the April Inflation Report. End-year inflation may be lower than projected in the baseline scenario presented in the Inflation Report, should the unprocessed food prices display a more favorable course than expected.
18. The Committee monitors fiscal policy developments closely while formulating monetary policy. Current monetary policy stance takes the framework outlined in the Medium Term Program as given. In this respect, it is assumed that there will be no additional deterioration in the budget balance in the second half of the year as well as no unforeseen hikes in administered prices. 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.
19. 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.