No: 2012-23 **Release Date: June 1, 2012**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: May 29, 2012

Inflation Developments

1. In April, consumer prices were up 1.52 percent and annual inflation increased to 11.14 percent. This rise was led by energy prices that were pushed upwards by the increase in electricity and natural gas tariffs. Meanwhile, core inflation indicators also increased amid the soaring clothing prices. In this period, annual inflation in energy and services went up, while it remained unchanged in core goods group.

2. In food and nonalcoholic beverages group, seasonally adjusted unprocessed food prices maintained the mild outlook of the last three months. As for the processed food group, annual inflation rose to 9.80 percent in April. Indicators related to May suggest that annual unprocessed food inflation will display a sharp fall due to the base effect in fresh fruits prices; while processed food inflation will continue to increase slightly.

3. In energy group, the rise in natural gas and electricity tariffs in April pushed up annual consumer inflation by 0.51 percentage point as envisaged, while prices remained moderate in other energy items. In May, the decline in fuel prices is expected to lower the annual rate of increase in energy prices.

4. On the services front, annual inflation went up by 0.56 percentage point to 6.73 percent in April, which was partially driven by the base effect in communication services. Meanwhile, the rise in restaurants-hotels and transport services is also noticeable. Seasonally adjusted price and diffusion indices suggest that the underlying trend of the prices of services edged up in this period. As for the core goods group, annual inflation remained unchanged in April. While annual inflation continued with its downward trend in durable goods, the uptrend in clothing and footwear accelerated due to the ongoing effects of the rise in import duties. Accordingly, annual rate of increase in core inflation indicators posted an increase as well.

Factors Affecting Inflation

5. The Committee stated that the deceleration in economic activity continued in the first quarter of 2012, which was attributed to domestic demand. Having plummeted in January, industrial production index picked up slightly in February and March; yet production stood below the figures of the previous quarter. In the

first quarter, domestic sales of vehicles posted a quarter-on-quarter decline. Meanwhile, having exhibited a mild growth, seasonally adjusted consumer loans confirmed the slowdown in domestic demand.

6. Leading indicators suggest a modest recovery for the second quarter. The Committee reiterated that the slowdown in economic activity in the early 2012 were driven by the tight policy measures besides some temporary factors such as adverse weather conditions and external uncertainties, and domestic demand would post an increase in the second quarter. Nevertheless, it is stated that the recent deterioration in the global economic outlook and the risk appetite might lead to a slower-than-expected recovery in economic activity. As a matter of fact, expectations for orders of the manufacturing industry firms exhibited a slight decline in the last two months.

7. Recent data confirm that the rebalancing between the domestic and external demand continues as envisaged. In March, a remarkable recovery was seen in 12-month current account balance as envisaged. Notwithstanding the persisting problems in the European economy, exports continue to grow at a steady pace. The ongoing slowdown in domestic demand and the cumulative depreciation in the Turkish lira continue to restrict the import demand and non-energy current account deficit. Moreover, the recovery in the terms of trade also contributes to the improvement in the current account balance. Accordingly, the current account deficit is expected to continue to decline gradually in the forthcoming period.

8. Employment followed a poor course in the first quarter amid the slowdown in economic activity. The downward trend in the construction sector employment, which started in the last quarter of 2011 and halted in January, continued in February. Moreover, the rate of increase in employment in the services sector recorded a marked loss of pace. As for the industrial sector, the trend of recovery was maintained, which has been evident since December 2011. While the leading indicators signal for a mild growth in employment in the short term, the ongoing downside risks on global economy may restrain employment growth in the period ahead.

Monetary Policy and Risks

9. The Committee noted that inflation will follow a volatile path in the short term. Although inflation will display a marked drop in May, it is expected to stay significantly above the target until the last quarter of the year. On the other hand, core inflation is expected to display a limited increase in the short term before starting to decline in the second half of the year.

10. According to the Committee members, the elevated levels of current inflation calls for a close monitoring of inflation expectations. Accordingly, the current tight policy stance will be maintained in the forthcoming period in order to contain risks

regarding pricing behavior. The Committee therefore continues to forecast the year-end inflation to be at 6.5 percent stated in the April Inflation Report.

11. The Committee members indicated that the downward slope of the yield curve points to the tight monetary policy stance. Moreover, moderate pace of consumer credit growth suggests that financial conditions are tight as well. Although corporate loans recently display some acceleration, this can be mainly attributed to supply-sided temporary factors and seasonal effects, and hence seen as a temporary development.

12. Developments during May have once again demonstrated the fragile state of the global economy, highlighting the essential role of the current policy framework adopted by the Central Bank of Turkey. The Committee stated that, given the prevailing uncertainties regarding the global economy, it would be appropriate to preserve the flexibility of the monetary policy. 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. In this respect, shorter episodes of additional monetary tightening may also be implemented, when necessary.

13. Moreover, in order to support financial stability, the Committee has approved a limited increase in the flexibility regarding the allowance to hold Turkish lira reserve requirements in foreign currency. The Committee members stated that this flexibility will ease the Turkish lira and foreign exchange liquidity management of the banks and hence act as an automatic stabilizer against external finance shocks.

14. On the other hand, the Committee members stated that, in order to lower the gap between the cost of holding foreign exchange and Turkish lira reserves, it would be useful to require a higher fraction of foreign exchange per each unit of Turkish lira for additional increases in allowance ratios. Accordingly, the upper limit of Turkish lira required reserves that can be held in foreign exchange and gold could be raised, if conditions permit, up to 60 percent and 30 percent gradually, with incremental increases in the fraction of foreign exchange or gold that can be held for each unit of required Turkish lira reserves.

15. The Committee monitors fiscal policy developments closely while formulating monetary policy. In this respect, current stance of the monetary policy take the Medium Term Program as given and thus assume that fiscal discipline will be maintained. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework and consequently have an adverse effect on the medium-term inflation outlook.

16. Strengthening the structural reform agenda to ensure the sustainability of the fiscal discipline and reduce the saving deficit will support the relative improvement

of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium term. These measures 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 the implementation of the structural reforms envisaged by the Medium Term Program remain to be of utmost importance.