Inflation Developments

1. In May, consumer prices edged up by 0.15 percent and annual inflation went up to 6.51 percent. This rise was attributed to the base effect in energy prices. Meanwhile, core inflation indicators remained on a mild track.

2. On the food and non-alcoholic beverages front, annual inflation went up to 7.07 percent. Processed food prices recorded an increase by 0.55 percent, while annual inflation receded to 8.19 percent in May. The group’s monthly inflation increased mainly due to the bread and cereals group; whereas the contribution of other processed food prices proved limited. On the other hand, mainly driven by the prices of fresh vegetables, unprocessed food prices fell by 5.33 percent; however, the group’s annual inflation registered an increase owing to the base effect. Leading indicators pertaining to June point that the group's annual inflation will soar.

3. Energy inflation maintained its favorable course owing to the decline in international oil prices, and the group’s prices fell by 0.69 percent in May. Meanwhile, due to the elimination of the favorable base effect in the last couple of months, annual energy inflation went up by 1.30 percentage points to 6.24 percent. The base effect led by energy prices is estimated to push inflation up in June, and pull it down considerably as of August.

4. Prices of services went up by 0.76 percent, and annual services inflation increased to 7.45 percent in May. This rise in annual inflation was mainly attributed to rents and communication services. Seasonally adjusted data suggest that inflation will trend upwards across the services group, particularly in rents. Meanwhile, the diffusion index remained almost unchanged on a monthly basis.

5. Annual inflation in core goods group did not record a noticeable change with 3.66 percent in May. Following a consecutive decline for three months, the clothing group recorded a limited increase in May; while core goods inflation excluding clothing and durable goods continued with a stable trend of deceleration. Seasonally adjusted figures settled on a downward track in May. Accordingly, despite the uptrend in services inflation, seasonally adjusted trends of core inflation indicators registered a decline.
6. In sum, the Monetary Policy Committee (the Committee) reiterated its projection that base effects would push the energy inflation up in June, and underlined that the course of unprocessed food prices would lead to a surge in annual inflation in June.

**Factors Affecting Inflation**

7. Recently-released data point that both domestic and foreign demand developments unfold as envisaged. National accounts data relating to the first quarter of 2013 released by the TurkStat suggest that economic activity increased in line with expectations. Triggered by public investments and private consumption, final domestic demand proved the largest contributor of growth in this period. On the other hand, exports remained flat in line with the weak global demand; while net exports contributed negatively to growth due to the increased import demand. Thus, the balancing trend among demand components was subject to a slight deterioration in the first quarter.

8. Data pertaining to the second quarter point to a healthy recovery in final domestic demand. Industrial production posted an increase in April compared to the first-quarter average. Production and imports of consumption goods, sales of automobiles, credit data and confidence indices also indicate that domestic demand will continue to improve. Indicators of investment display a favorable outlook; however, private investments are projected to have a limited contribution to growth in the second quarter.

9. Data regarding foreign trade and the current account balance are evolving in line with expectations. Exports slow down due to weak global demand. As for imports, an increase was recorded upon the revival in domestic demand besides the rise in demand for gold imports. This is expected to create a slight increase in the current account deficit. However, the Committee has kept its view that the current policy framework and the decline in commodity prices would contain the widening in the current account deficit.

10. Seasonally adjusted data suggest that non-farm employment posted a plausible increase in March 2013; yet remained incapable of covering the increase in labor force participation, which led to a rise in unemployment rates. The increase in non-farm employment was mainly driven by the services sector besides the industrial sector, which settled on a trend of recovery in the last quarter of 2012. Meanwhile, employment in the construction sector remained flat. Survey indicators suggest that industrial employment has been on an upward track within the second quarter. The Committee expects that total employment will register mild increases in the period ahead. Nevertheless, uncertainties regarding the
global economy remain critical as they may restrain employment growth in the forthcoming period.

Monetary Policy and Risks

11. Amid the increased uncertainty regarding global monetary policies, capital inflows have recently slowed down. Uncertainty about the exit strategy from quantitative easing policies implemented by the central banks of leading advanced economies as an integral part of accommodative monetary policies resulted in capital outflows from emerging economies. Besides uncertain monetary policies, the ongoing deleveraging process in advanced economies and persisting impediments in the monetary transmission mechanism leads volatility to remain high.

12. The Committee assessed that the reserve options mechanism (ROM) functions as an automatic stabilizer against volatile capital inflows. Banks increased the amount of foreign exchange reserves through the ROM in times of strong capital inflows, and they used these reserves held at the Central Bank in times of capital outflows. Thus, the ROM contributed to contain the volatility in exchange rates.

13. The Committee stated that short term additional monetary tightening and foreign exchange selling auctions may be implemented when deemed necessary; and did not opt for any change in monetary policy instruments. Meanwhile, the Committee declared that credit growth rates hover above the reference rate both in consumer and business loans.

14. The Committee expressed that the effects of properly recovering domestic demand, credit growth above the reference rate and the exchange rate movements driven by global uncertainties on the pricing behavior would be closely monitored. Ongoing uncertainties regarding the global economy and the volatility in capital flows necessitate the monetary policy to remain flexible in both directions. In this respect, the Committee stated that necessary adjustments would be made in the composition of Turkish lira liquidity provided by the Central Bank. The leading instrument in the adjustment of liquidity composition is the foreign exchange selling auctions that enable shifting from net foreign assets to net domestic assets and from permanent liquidity to short-term funding. The Committee assessed that foreign exchange selling auctions would contain excessive depreciation pressure on the exchange rates under the market conditions; and also ease the rapid credit growth by shifting the TL liquidity to shorter maturities.
15. The Committee monitors fiscal policy developments and tax adjustments closely, with regard to their effects on the inflation outlook. In the setting of monetary policy, the framework outlined in the Medium Term Program is taken as given. In this respect, it is assumed that fiscal discipline will be sustained and there will be no unanticipated hikes in administered prices. 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. Prudent fiscal and financial sector policies are crucial for preserving the resilience of our economy against existing global imbalances. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the savings deficit would support macroeconomic stability in the medium-term. This will also provide more flexibility for monetary policy and improve social welfare by keeping interest rates of long-term government securities persistently at low levels. In this respect, implementation of the structural reforms envisaged by the Medium Term Program remains to be of utmost importance.