

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: October 20, 2011

Inflation Developments

1. In September, consumer prices were up by 0.75 percent and annual inflation went down to 6.15 percent. As envisaged, the annual rate of core price indicators kept rising parallel to the exchange rate movements, while the underlying trend of the prices of services remained moderate in sub-categories except transportation.
2. Annual inflation in food and non-alcoholic beverages group declined to 2.23 percent due to the base effect in unprocessed food prices. Besides the base effects, monthly unprocessed food prices displayed a positive outlook owing to the prices of fruits and vegetables as well. On the other hand, price increases which spread across sub-categories in the processed food group continued in September, bringing annual inflation up to 9.07 percent. Floods in October are estimated to push up the unprocessed food prices to some extent; however, the high base effect of the last year is expected to contain the group's annual inflation.
3. Prices of services rose by 0.88 percent in September, and annual services inflation went up to 6.36 percent. Price increases in fuel and processed food continued to spill over into prices of transport and catering services. In September, annual inflation went up across all sub-categories of services, while underlying trend was more benign, as suggested by the seasonally adjusted data.
4. Annual core goods inflation reached 7.64 percent in September amid the depreciation of the Turkish lira. Prices of durable consumer goods became the largest contributor of this increase. The annual inflation in clothing group, which has been rising steadily since November 2010, declined in September. However, this is likely to reflect the season-specific temporary discounts. Owing to the protective measures in textiles and apparel imports, inflation in the clothing group is expected to rise again in the last quarter of the year.
5. Administered price increases will have an upward effect on inflation in the short term. The Special Consumption Tax rates were raised on some motor vehicles, mobile phones, alcoholic beverages and tobacco products by a Decision by the Board of Ministers, which was published on the Official Gazette on October 13, 2011. The impact of the tax hikes on consumer

inflation will occur mainly through the increases in the prices of tobacco products, while the contribution of other items will remain relatively small.

Factors Affecting Inflation

6. Recent data releases suggest that there will be a notable reduction in economic growth in the second half of the year. The August data justified the Committee's evaluation that production developments in July do not reflect the main trend. As a matter of fact, seasonally adjusted industrial production contracted in August, returning to the levels in June. The Committee stated that global problems would continue to restrain industrial activity.
7. Final domestic demand continues to slow down. Due to the depreciation in the Turkish Lira, the demand for durable goods, particularly the sales of vehicles, is expected to keep weakening. Besides the weak course of consumer confidence, the marked slowdown in loans supports this view. In addition to credit developments, the low levels of capacity utilization rates and mounting uncertainty in demand put a cap on investments. All of these developments signal that the slowdown in domestic demand may persist.
8. External demand remains weak. Recent downward revision of growth forecasts for the U.S. and the euro area points to a steadily worsening outlook for the global economy. The Committee underlined that the outlook for the world economy noticeably deteriorated compared to the first half of the year and that global problems would continue to restrain foreign demand.
9. Recent data releases suggest that the rebalancing between the domestic and external demand is ongoing as envisaged. The Committee stated that external demand remains weak, yet the persisting slowdown in domestic demand would restrain imports in the forthcoming period. With the credit growth decelerating to more reasonable levels, the desired increase in private savings has already started to take place. Accordingly, the Committee has noted that there is a significant improvement in the current account balance and this trend will be more evident in the final quarter of the year.
10. In July, seasonally adjusted non-farm employment posted a limited increase, while unemployment rates declined owing to the fall in the labor force participation rate. In this period, increases remained modest in the services and construction sectors, which have been marked by high employment growth rates since the second half of 2010. Meanwhile, the downward trend in the industrial sector employment continued. Leading indicators point that employment conditions in the industrial sector are expected to remain weak.

Given the slowdown in economic activity, the Committee envisaged that employment conditions in the particular service sectors such as trade and transport-communications would deteriorate.

Monetary Policy and Risks

11. The Committee has assessed the forecasts prepared for the October Inflation Report. It was indicated that inflation would rise significantly in the upcoming months due to the recent excessive depreciation of the Turkish lira, base effects from unprocessed food prices and the recent adjustments in administered prices. The Committee has reached full agreement stating that the Central Bank should not tolerate these developments to have an adverse impact on medium term inflation expectations and inflation outlook. In this respect, the Committee has decided to widen the interest rate corridor by increasing the lending rate significantly.
12. The projections have been based on the assumption that the policy reaction of the Central Bank will prevent the second round effects. Moreover, the Committee members indicated that, given the weak prospects for the global economy, the course of commodity prices would also support the disinflation process. Accordingly, the forecasts were based on an outlook where inflation decelerates gradually starting from early 2012 and materializes at levels close to target by the end of 2012.
13. The fact that inflation will hover above target in the short term poses risks regarding inflation expectations and price setting behavior. The Committee has adopted a policy stance as of October aiming to eliminate these risks. The risks will be closely monitored and necessary measures will be taken to avoid a deterioration in the inflation outlook.
14. The medium term projections assume that global outlook will stay weak for a long period, but the situation will not worsen further. Nevertheless, the Committee members noted that uncertainties regarding the global economy continue to be an important concern. Especially, mounting problems regarding sovereign debt of the euro area economies continue to pose downside risks on the global economy. Concerns regarding the debt sustainability of euro area economies have further increased since the publication of the July Inflation Report, increasing the concerns of a possible contagion to region's banking sector. The Committee will continue to monitor global developments closely; and in line with the strategy formulated at the interim meeting of August 4, 2011, will take the needed measures promptly to maintain the stability in the domestic financial markets.

15. The Committee will continue to monitor fiscal policy developments closely while formulating monetary policy. In this respect, our forecasts presented in the baseline scenario 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. 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 CBRT 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 long term interest rates permanently at low levels. In this respect, timely implementation of the structural reforms envisaged by the new Medium Term Program remains to be of utmost importance.