No: 2011 – 34 **26 August 2011**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: August 23, 2011

Inflation Developments

1. Consumer prices went down by 0.41 percent in July, whereas annual inflation edged up to 6.31 percent as envisaged in the July Inflation Report. Core goods (excluding food, energy, alcoholic beverages, tobacco and gold) inflation remained flat in this period, while the services inflation went up. Therefore, core inflation indicators continued to increase.

2. Annual inflation in food and non-alcoholic beverages declined to 7.65 percent. Despite the rise in vegetable and meat prices, unprocessed food prices decreased by 3.65 percent amid the decline in fruit prices. On the processed food front, prices of bread, cereals and processed meat went up. Moreover, the rising trend in prices of fats and oils continued, and sugar prices posted an increase. Accordingly, annual processed food inflation rose to 8.25 percent. The uptrend in processed food prices is expected to continue in August as well.

3. Prices of services were up 0.74 percent, while annual services inflation increased to 5.39 percent. Prices of transport services continued to increase due to higher fuel prices and are expected to remain on the rise over the forthcoming period. While rents maintained their moderate increase, prices of tour packages soared. Consequently, the underlying trend of services inflation posted a limited increase.

4. The recent upward trend in annual core goods inflation halted in July. Annual inflation maintained its uptrend in clothing but went down in durable goods (excluding gold). On a month-on-month basis, furniture prices increased, whereas prices of white goods declined. Meanwhile, the Monetary Policy Committee (the Committee) has noted that core goods inflation may increase temporarily in the short term due to exchange rate pass-through.

5. Although annual core inflation indicators continued to increase in July, seasonally adjusted monthly data pointed a decline in the recent underlying trend. Yet, due to exchange rate pass-through, core inflation is expected to increase slightly in August.

Factors Affecting Inflation

6. Recent data releases confirm the Committee's assessment that global economic activity continues to decelerate. Accordingly, external demand remains weak. Core euro area economies grew at a slower-than-expected pace in the second quarter and July's PMI data point to a worsening outlook. In addition, short and medium-term US growth forecasts of various institutions have been revised downward. The Committee has stated that the global growth outlook is deteriorating amid recent developments in August. The Committee members have noted that, despite the competitiveness gains due to the recent exchange rate movements, global developments would continue to restrain external demand.

7. Signals of a slowdown in economic activity are growing stronger. Seasonally adjusted industrial production data posted a month-on-month decrease of 0.9 percent in June, recording a decline for five consecutive months. The slowdown in capacity utilization since February became more evident in July, leading to a cumulative decline of about 4 percentage points compared to January. July data on the expectations for new orders, which serve as a leading indicator, signals that manufacturing activity might remain weak in the third quarter as well.

8. There is an ongoing slowdown in final domestic demand since the second quarter. Leading indicators for August suggest that the ongoing weakening in consumer confidence has become more pronounced. Moreover, investment appetite has decelerated for the first time in a long while. Domestic sales of automobiles and light commercial vehicles, which remained below the previous quarter's average in July, are expected to decrease further amid the weakening Turkish lira. All these developments signal that the slowdown in domestic demand may deepen.

9. The unemployment rate hovers around pre-crisis levels. Yet, due to the decline in industrial employment in May, non-farm employment growth slowed and unemployment rates posted a slight quarter-on-quarter increase in seasonally adjusted terms. Leading indicators suggest that this slowdown in employment would continue in the third quarter as well.

Monetary Policy and Risks

10. The Committee has noted that inflation may temporarily hover slightly above the levels envisaged in the July Inflation Report and core inflation may continue to rise for some time. However, due to the slowdown in the economic

activity, it is expected that the second round effects of exchange rate movements would be limited, and thus the increase in inflation would be temporary. Core inflation indicators are expected to start falling again by the end of the year. Moreover, inflation outlook for the end of 2012 is seen consistent with the 5 percent target.

11. According to the Committee, in an environment of increasingly slowing economic activity and ongoing macro financial risks, it would not be an optimal response to react to temporary price movements. However, it was stated that it is important to monitor inflation expectations closely and take the necessary measures if there is a deterioration in the pricing behavior that may hamper the attainment of medium term targets.

12. The slowdown in credit growth and domestic demand combined with the exchange rate movements have been contributing to the rebalancing of domestic and external demand. Credit growth continues to slow down across all subcategories, with the deceleration in general purpose consumer loans being more pronounced. Moreover, cumulative movements in the exchange rate would put a significant restraint on the import demand in the second half of the year. Accordingly, the Committee expects a notable improvement in the current account balance in the forthcoming period. It was reiterated that monitoring the seasonally adjusted monthly data is more informative in assessing the underlying trend of the current account balance. Still, the Committee members have highlighted the important role of structural measures that would boost productivity and increase the saving rate, in order to stabilize the current account deficit at reasonable levels in the medium to long term.

13. The Committee has agreed that the measures taken at the interim meeting on August 4, 2011 have contained the downside risks for the economy for the time being, and thus decided to keep the policy instruments unchanged at this meeting. However, given the uncertainties regarding the global economy, it is important to monitor all developments closely, and to deliver the required policy response in a timely manner. The Committee has also reiterated that all policy instruments may be eased should global economic problems further intensify and the slowdown in domestic economic activity becomes more pronounced.

14. 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 Central Bank 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 interest rates permanently at low levels. Therefore, addressing these issues in the new Medium Term Program and progressing with the structural reforms envisaged by the European Union acquis communautaire remains of utmost importance.