

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: July 19, 2012

Inflation Developments

1. In June, consumer prices were down 0.90 percent, while annual inflation increased to 8.87 percent. As also indicated in the previous Summary of the Monetary Policy Committee Meeting, the favorable course of energy and unprocessed food prices contained the base-effect-driven rise in inflation. Meanwhile, the annual rate of increase of core inflation indicators went down.
2. In June, seasonally adjusted unprocessed food prices posted a decline and maintained their mild course. However, annual rate of price increase in food and nonalcoholic beverages group went up to 7.38 percent due to the base effect. Leading indicators for July suggest that unprocessed food prices will rise due to the developments in the prices of fresh fruit.
3. On the processed food front, being mainly driven by prices of bread and cereals, oils and fats, the increasing trend was sustained. The cumulative increase especially in bread prices totaled nearly 8 percent in the first six months, which was led by the arrangements in the Communique on Bread and Bread Varieties of the Turkish Food Codex. These effects may continue have an adverse impact on processed food prices in the short term.
4. Energy prices continued to decline in June parallel to easing domestic fuel prices. Although developments in the first half of July indicate that the decline in energy prices continue, the upward trend in international oil prices as of the end of June poses a risk to inflation in the short term.
5. On the services front, annual inflation remained unchanged month-on-month at 6.94 percent in June. Annual inflation decreased in transport services, while it increased in communication services and rents. Although diffusion index edged up in this period, seasonally adjusted price data indicated a flat course in the underlying trend of the prices of services.
6. As for the core goods group, annual inflation maintained its downward trend with 7.93 percent. While annual inflation in durable goods and clothing went down in this period, other core goods items posted increases. Seasonally adjusted data suggest that the underlying trend of core goods inflation slowed down remarkably

at the end of the second quarter. These developments led the underlying trend of core inflation indicators to continue to go down.

7. In sum, mainly due to the developments in food and energy prices, mid-year inflation was lower than projected in the April Inflation Report.

Factors Affecting Inflation

8. National accounts data for the first quarter of 2012 suggest that economic activity remained consistent with the outlook presented in the April Inflation Report. While domestic demand posted a mild increase in this period, net foreign demand made a larger-than-expected contribution to annual growth. In other words, the rebalancing process in the economy continued with a stronger pace. While national income posted a quarterly decline in the first quarter, it was reiterated that this slowdown reflected temporary factors.
9. Second-quarter indicators confirmed that the negative course in the first quarter did not tend to be persistent and that the economy would return to a mild growth path in the subsequent period. In fact, industrial production recorded a strong growth in the April-May period compared to the previous quarter. The Monetary Policy Committee (the Committee) members assessed that this also entailed a compensation for the unfavorable outturn in the first quarter and therefore the underlying trend in the economic activity followed a mild course despite the brisk recovery.
10. The Committee noted that signals for a slowdown in the economy, which gradually spread across the globe in the May-June period, posed downside risks to the foreign demand outlook pertaining to the second half of the year. Problems in the European economies, primarily in the Greek and Spanish context, weigh on the perceptions of uncertainty. Meanwhile, economic activity and labor market trends in the Chinese and US economies exhibited poor figures for the global growth outlook.
11. Despite global economic problems, exports entailed a stronger underlying trend compared to the pre-crisis period. The Committee stated that this could be attributed to the lagged effects of rebalancing policies besides market diversification in foreign markets. In fact, the rebalancing process continued in the second quarter, which bolstered economic fundamentals and perceptions regarding the Turkish economy. Despite a slight deterioration in expectations for orders in the manufacturing industry and the retail sector, indicators for medium/long term expectations like employment, investment plans and consumer confidence point to a comparatively more favorable outlook.

12. Employment followed a weak course amid the slowdown in economic activity in the first months of the year and the downtrend in unemployment rates paused. Amid the mild recovery in economic activity, non-farm employment declined again in the April period. Trends in recent months suggest that the industrial employment recovered further and services employment lost momentum. Having boosted in April, the construction employment largely compensated for the plunge in February. Although leading indicators signal for a mild growth in employment in the short term, ongoing downside risks on the global economy may restrain employment growth in the period ahead.

Monetary Policy and Risks

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

14. The meeting also involved an assessment of the inflation forecast prepared for the July Inflation Report. The Committee has indicated that the year-end inflation forecast is likely to be revised slightly downwards due to recent favorable developments in factors affecting inflation. However, it was stated that pricing behavior should be closely monitored as inflation will continue to stay above the target for some time. Although the monetary tightening implemented since last October and the moderate aggregate demand outlook reduce the likelihood of second round effects, pricing behavior will be monitored closely in the forthcoming period.

15. Ongoing uncertainty regarding the global economy requires the maintenance of a flexible approach in monetary policy. 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. Therefore, it is highly likely that short term capital inflows will continue to be volatile in the forthcoming period. In this respect, also considering the prevailing uncertainties regarding the global economy, the Committee has stated that it would be appropriate to preserve the flexibility of the monetary policy. 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.

16. Moreover, 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. Accordingly, the upper limit for the FX reserves that can be held

to fulfill Turkish lira reserve requirements has been raised from 50 percent to 55 percent, with a multiplier of 1.9 for the additional 5 percent tranche. The Committee members have reiterated that this mechanism is designed to contain the adverse effects of the excessive volatility in capital flows on domestic markets.

17. The Committee has also assessed the risk scenarios that could have an impact on inflation and monetary policy outlook and possible policy reactions. According to the Committee members, 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 through reserve requirements, utilizing the mechanism it has developed for reserve requirements by increasing the coefficients which define the amount of foreign exchange to be held per unit of Turkish lira reserve requirements.
18. It is also likely that problems in the Euro Area may further intensify, given the ongoing deleveraging process in banking, household and public sector balance sheets and possible delays in the institutional mechanisms to resolve the related problems. Should such a risk materialize, the immediate reaction could be to implement an active liquidity policy via the interest rate corridor; to be followed by measures to relieve the tension in the banking system through the use of reserve requirements as well as other liquidity instruments.
19. On the other hand, aggregate demand and commodity prices may increase faster than expected, should the measures taken towards the solution of problems regarding the global economy are completed sooner and more decisively than envisaged. Materialization of such a risk would possibly require a tightening using all policy instruments, as it would mean increased pressures on the medium-term inflation outlook.
20. 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.
21. Unprocessed food prices pose downside risks for the inflation outlook in 2012, as indicated in the April Inflation Report. The revised forecast adopts a rather cautious approach, assuming a reversal in the favorable trend observed during

the first half of the year. End-year inflation may be lower than projected in the baseline scenario presented in the new Inflation Report, should the unprocessed food prices display a more favorable course than expected.

22. 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.
23. Maintaining the prudent fiscal policy implemented in recent years is crucial for preserving the resilience of our economy against existing global uncertainties. Strengthening 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.