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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: June 23, 2011

Inflation Developments

1. In May, consumer prices were up 2.42 percent, while annual inflation rose by about 3 percentage points to 7.17 percent. This increase was largely driven by the spike in fresh fruit prices due to seasonal variations. On the other hand, the annual rate of increase in core inflation indicators edged up slightly month-on-month as expected.

2. The summary of the May meeting stated that soaring fruit prices could put significant upward pressure on unprocessed food inflation. Indeed, the fruit price index rose by a stronger-than-expected 76.12 percent month-on-month, as some goods entered May's index at very high prices due to supply side developments. The Committee has noted that this jump in unprocessed food inflation would largely reverse in June and annual inflation would fall back to the forecasted path in the Inflation Report.

3. Annual services inflation increased slightly to 4.44 percent due to base effects. Developments across subcategories do not suggest any upward pressure on services inflation. In fact, recent seasonally adjusted figures indicate that services inflation maintains its moderate pace.

4. Annual core goods (excluding food, energy, alcoholic beverages, tobacco and gold) inflation continues to rise. Seasonal increases in clothing prices were higher than the previous year, whereas, among durable goods, furniture and automobile prices decelerated and prices of white goods fell, reversing the upsurge in previous months.

5. Although core inflation indicators increased in annual terms in May due to developments in services and core goods, their underlying trend implied by the seasonally adjusted figures appears to have slowed.

Factors Affecting Inflation

6. Recent data releases are consistent with the outlook presented in the Inflation Report. After a robust first quarter fueled by strong domestic demand, economic activity slowed in the second quarter. Indeed, industrial production dropped month-on-month for three consecutive months during February-April, dipping below the first quarter's average in April. The Committee has noted that the slowdown in sectors sensitive to external demand has been more pronounced.

7. Private consumption and investment growth rates are moderating. The strong growth in private demand decelerated in the second quarter. April's production and imports of consumer goods and production of capital goods were down from the first quarter. April-May sales data also confirm the slowdown in private demand.

8. External demand outlook remains weak. Recent data point to a limited recovery in exports for the second quarter. The flat course of 3-month ahead expectations for new orders signals that external demand conditions are unlikely to improve significantly over the short term. Considering the mounting uncertainty about the global economy, the Committee has emphasized that downside risks to external demand have increased. In this regard, the Committee has reiterated that exports would recover slowly and gradually.

9. Employment conditions continue to improve, with unemployment rates having returned to pre-crisis levels. The first quarter's faster-than-expected employment growth continued into March, albeit at a slower rate. Leading indicators suggest that this uptrend would continue at a slower pace in the short term. The Committee has stated that improved employment conditions support domestic demand, yet unit labor costs decline due to strong productivity gains.

Monetary Policy and the Risks

10. The Committee reiterated its view that aggregate demand conditions do not indicate an overheating. Recently, domestic demand moderates while low levels of capacity utilization rates persist due to weak external demand. Orders and sales data as well as confidence indices confirm the slowdown in the pace of domestic demand growth during the second quarter.

11. Given the lagged impact of rising import prices and base effects, core inflation is expected to increase at a moderate pace over the short term. The Committee members have underscored that this increase reflects a relative

price adjustment of tradable goods rather than a deterioration in the overall pricing behavior; and thus, second round effects are not observed yet.

12. The recent measures taken by the Banking Regulation and Supervision Agency towards consumer loans will contribute to the rebalancing of domestic and external demand through controlling the fast credit growth. These measures also reduce the need for additional hikes in reserve requirement ratios. The Committee has reiterated that, owing to the measures taken since last November, the current account balance will start to improve in the final quarter of the year.

13. According to the Committee members, it would be appropriate to remain flexible regarding the exact content of the policy mix, given the high level of uncertainty arising from the global economic conditions. Although fragilities in the global economy are of particular concern, the main risk scenarios outlined in the Inflation Report continue to be relevant.

14. In light of these assessments, combined with the considerations about the ongoing uncertainty regarding the global economy and the slowdown in domestic economic activity, the Committee has decided to maintain the current policy stance. In order to contain the risks towards price stability and financial stability, the Committee has decided to monitor the tightening impact of the existing policy mix and take additional measures along the same lines, if needed.

15. The meeting also included an evaluation of the course of capital inflows and foreign exchange purchase auctions. The Committee members highlighted the persistence of relative weakness in capital flows towards emerging markets that is due to heightened concerns regarding debt sustainability problems in some euro area countries, and stated that, depending on circumstances, it might be useful to further revise the amount of foreign exchange purchases via daily auctions. It was reminded that the auction amount could continue to be reduced gradually should the weakening in capital flows persist. The Committee reiterated that, such a development would lower the liquidity injected into the market and thus ease the need for further hikes in reserve requirements to curb credit growth in the second half of 2011.

16. The CBT will continue to monitor fiscal policy developments closely while formulating the monetary policy. Increasing government saving—thus sustaining fiscal discipline—under current circumstances is essential to control the current account deficit driven by the disparity between domestic and external demand. Therefore saving the extra tax revenues driven by the stronger-than-expected economic activity would not only reduce the risks against price stability and financial stability, but also increase the efficiency of the implemented policy mix.

17. 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 CBT 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. In this respect, timely implementation of the structural reforms envisaged by the Medium Term Program and the European Union acquis communautaire remains to be of utmost importance.