No: 2012 – 29 **Release date: 28 June 2012**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: June 21, 2012

Inflation Developments

1. In May, consumer prices were down 0.21 percent and annual inflation decreased to 8.28 percent. This decline was led by the favorable course of unprocessed food prices besides falling energy prices in line with international economic developments. Clothing prices stood as another factor to contribute to disinflation; and core inflation indicators went down in this period.

2. Annual rate of price increases in food and nonalcoholic beverages group plummeted due to the high base in unprocessed food prices. Setting aside the base effect, seasonally adjusted unprocessed food prices maintained their mild course by displaying a month-on-month decline. On the processed food front, the increasing trend was sustained, bringing the annual rate of increase to 10.29 percent. Although June indicators suggest that monthly unprocessed food prices maintain the moderate outlook, the reversal of the base effect is expected to lead to a limited increase in consumer inflation.

3. Easing international commodity prices is having a favorable effect on inflation. In fact, energy prices dropped by 1.9 percent in May. Mostly driven by fuel prices, this trend is expected to continue in June.

4. On the services front, annual inflation went up to 6.92 percent in May. This increase is attributed to the base effect in communication services besides the rise in prices of restaurants, hotels and transport services, as in the previous month. Seasonally adjusted price and diffusion indices do not point to an increase in the underlying trend of the prices of services.

5. As for the core goods group, annual inflation went down to 8.42 percent. While durable goods prices decreased by 0.65 percent, clothing and footwear prices, which soared in April, increased at a rate quite below the seasonal averages in May. Although May inflation indicators reflect the related development in clothing prices, core inflation indicators excluding clothing prices also exhibited a downward trend.

6. In sum, mainly due to the developments in unprocessed food and energy prices, inflation followed a more favorable path compared to the projections in April Inflation Report.

Factor Affecting Inflation

7. While domestic demand shows a significant slowdown in the first quarter, leading indicators suggest a modest recovery for the second quarter. Both survey indicators and the credit data signal that consumption demand assumed a mild trend of growth following the slump in January. In fact, having tumbled in January, industrial production index picked up within three consecutive months. Nevertheless, due to the deterioration in the recent global growth outlook and the risk appetite, it was mentioned that the recovery in economic activity may be slower than expected in the second half of the year. Problems in the euro area 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 point to a weakening in the global growth outlook. In line with these developments, expectations for orders of domestic manufacturing firms also trended downwards.

8. Recent data confirm that the rebalancing between the domestic and external demand continues as envisaged. Exports continue to grow despite the weakening global outlook. Decelerating domestic demand coupled with the cumulative depreciation in the Turkish lira continue to restrict the import demand and non-energy current account deficit. Accordingly, the gradual decline in the current account deficit is expected to continue in the forthcoming period.

9. 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. Meanwhile, non-farm employment posted an increase in March period amid the mild recovery in economic activity, which was supported by all main sectors. Trends in recent months suggest that the industrial employment continued to recover and services employment maintained its upward movement at a slowing pace, whereas construction employment remained weak. 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

10. The Committee has indicated that monetary policy framework adopted since end-2010 has been quite effective in rebalancing the economy and reducing macro-financial risks. This assessment is supported especially by the slowdown in consumer loan growth and the consequent improvement in the current account balance. Moreover, the moderation in economic activity and the fall in commodity prices contribute to the ongoing rebalancing process.

11. Energy and unprocessed food prices follow a more favorable course than envisaged in the April Inflation Report, leading to a better inflation outlook. In this

respect, it was noted that the expected increase in inflation to be led by the base effect in June would be more limited than implied by earlier projections. In addition, aggregate demand conditions support the downward trend in inflation in line with the weakening in global economic outlook. Consequently, inflation is expected to stay below the path projected in the April Inflation Report in the forthcoming months.

12. However, pricing behavior should be closely monitored as inflation will continue to stay above the target for some time. Although medium term inflation expectations are relatively stable, the Committee highlighted that year-end inflation expectations remain significantly above the target. Therefore, additional monetary tightening may be implemented along the guidance presented in the April and May Committee meetings.

13. The Committee stated that, given the prevailing uncertainties regarding the global economy, it would be appropriate to preserve the flexibility of the monetary policy. In this respect, it was reiterated that having the room for maneuver provided by the wide interest rate corridor coupled with the effective liquidity management is particularly important under current circumstances. Therefore, 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.

14. Moreover, in order to support financial stability, the Committee has approved an additional increase in the flexibility regarding the allowance to hold Turkish lira reserve requirements in foreign currency and gold. The Committee members have underscored that these measures aimed at containing the adverse effects of the excessive volatility in capital flows on domestic markets. Moreover, it was reminded that should eligible conditions arise, the upper limit for Turkish lira required reserves that can be held in foreign exchange and gold could be raised up to 60 percent and 30 percent gradually with incremental increases in the fraction of foreign exchange or gold that can be held for each unit of required Turkish lira reserves.

15. The Committee monitors fiscal policy developments closely while formulating monetary policy. Although annual growth rate of tax revenues declined due to the slowdown in economic activity in the first half of the year, primary expenditures has largely been under control. Current stance of the monetary policy takes the Medium Term Program as given and thus assumes that fiscal discipline will be maintained. Besides, the projections presented in the April Inflation Report are based on the assumption that there will be no marked increase in administered prices for the rest of the year. 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. Strengthening the structural reform agenda to ensure the sustainability of the fiscal discipline and reduce the saving deficit will support the relative improvement of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium term. These measures 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 to be taken for the implementation of structural reforms envisaged by the Medium Term Program remain to be of utmost importance.