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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: November 19, 2013

Inflation Developments

1. In October, consumer prices edged up by 1.80 percent while annual inflation went down to 7.71 percent, which was mostly attributed to energy prices. With the delayed effects of exchange rate movements since May, core inflation indicators remained on an upward track.

2. Annual food inflation surged to 11.13 percent due to unprocessed food prices, driven by fresh fruit and vegetable prices. Thus, annual unprocessed food inflation rose to 14.95 percent in October. On the processed food front, despite rising bread and cereal prices, annual inflation declined to 8 percent thanks to slowing price increase of other processed food items.

3. October's energy prices edged down by 0.38 percent, due to the fall in local fuel prices largely amid decreasing international oil prices. In addition, with pulling out of last year's massive price hikes, annual energy inflation receded to 2.14 percent.

4. Annual services inflation fell to 7.86 percent in October. Seasonally adjusted data suggest that the underlying trend of services inflation decreased on a monthly basis. Annual core goods inflation increased to 7.10 percent due to delayed effects of exchange rate developments. The increase in prices of durable consumer goods continued while seasonal hikes in clothing prices were above the previous years. Hence, core inflation indicators remained elevated in October.

Factors Affecting Inflation

5. Recent data releases point to moderation in final domestic demand for the third quarter. The production and imports of consumer goods increased quarter-on-quarter during the third quarter. Similarly, data on sales of appliances and automobiles indicate a third-quarter increase in consumer demand. Meanwhile, investments remain weak. The production of capital goods, an indicator of investment demand, was up quarter-on-quarter, but mainly on exports, not domestic demand. The large third-quarter decline in imports of capital goods suggests that investments on machinery and equipment have not recovered yet.

6. On the production side, economic activity experienced a mild slowdown during the third quarter. The industrial production index saw a solid growth in September, which, however, was an offset to the August plunge. In fact, industrial production posted a slower quarterly growth in the third quarter.

7. Data on the latest quarter suggest that economic activity will continue to grow moderately. Although the October PMI data point to some slowdown, the Business Tendency Survey's three-month ahead expectations were significantly higher on both domestic and exports markets. Among indicators of confidence, a key ingredient for private consumer and investment demand, both the consumer confidence index and the firms' prospects for new investments increased.

8. Recent indicators suggest that exports continue to grow modestly. The non-gold export volume index was slightly up from the second-quarter average in the third quarter. After prolonged sluggishness, the import demand from the EU, Turkey's top trading partner accounting for a substantial portion of Turkish exports, has displayed some recovery lately. Moreover, global PMI data show signs of global economic recovery. Thus, external demand conditions are expected to support exports in coming months.

9. Foreign trade and current account balance are in line with expectations. In 12-month cumulative terms, non-gold exports remain on a modest uptrend, while non-gold imports post a relatively slower growth. Accordingly, despite the likely short-term increase, driven by base effects from gold trade, in the annual cumulative current account deficit, the gradual improvement in the non-gold trade current account deficit will continue.

10. In the third quarter, seasonally adjusted unemployment rose quarter-on-quarter on slowing non-farm employment. The slowdown in non-farm employment was evident across all subcategories. However, leading indicators for industrial employment show some improvement for September-October and suggest that employment will no longer weaken in the fourth quarter. Yet, global economic uncertainties remain a constraint to investment and employment growth over the upcoming period.

Monetary Policy and Risks

11. In light of these developments, the Committee assessed that final domestic demand and exports continue to grow at a moderate pace. Third quarter data suggest a limited slowdown, while indicators regarding the final quarter exhibit some recovery in economic activity. According to the judgment of the Committee, aggregate demand conditions suggest that output gap is close to zero.

12. Besides the level of the output the composition is also closely monitored with regard to its implications on the external balance. The present policy framework is contributing to the improvement in the current account balance. The cautious monetary policy stance, recently announced macroprudential measures, and weak capital flows have led to a notable tightening in financial conditions, which is expected to bring down the loan growth rates to more reasonable levels in the forthcoming period. Accordingly, moderate decline in the current account deficit excluding gold trade is expected to continue.

13. Inflation indicators are likely to hover above the inflation target for some time due to the exchange rate volatility observed during the recent months. In order to contain the impact of these developments on the pricing behavior, the Committee decided to strengthen the cautious stance and reduce the volatility of short term money market rates.

14. The Committee indicated that decreasing the volatility of interest rates in response to the weakening capital flows would be help to contain the adverse effects of the uncertain global monetary policy on the domestic economy. Therefore, the Committee agreed to adopt a monetary policy stance in which short term interest rates follow a more predictable and stable course.

15. The Committee stated that a liquidity management strategy that keeps the interbank overnight rate close to the upper bound of the interest rate corridor would not only limit the volatility of short term interest rates but also point to a more cautious policy stance. To this end, one month repo auctions will be terminated and thus the central bank funding will be conducted largely through overnight lending, as a result of which interbank money market rates will materialize around 7.75 percent. This decision will lead to a tightening through both a shortening in the maturity of the central bank funding and also through an increase in the marginal lending rates.

16. The Committee stated that the cautious monetary policy stance should be maintained until the inflation outlook is in line with the medium term targets. It was underscored that, given the recent developments in monetary and financial conditions, monetary policy stance is appropriate. However, it was also stated caution should be exercised against developments that may worsen the inflation outlook.

17. The Committee monitors fiscal policy developments and tax adjustments closely with regard to their effects on the inflation outlook. The baseline monetary policy stance takes the fiscal framework outlined in the Medium Term Program as given. Accordingly, it is assumed that fiscal discipline will be sustained and there will be

no unanticipated hikes in administered prices. 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.

18. Prudent fiscal and financial sector policies are crucial for preserving the resilience of our economy against existing global imbalances. Strengthening the structural reform agenda that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium-term. This will also provide more flexibility for monetary policy and improve social welfare by keeping interest rates of long-term government securities persistently at low levels. In this respect, implementation of the structural reforms outlined by the Medium Term Program remains to be of utmost importance.