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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: December 17, 2013

Inflation Developments

1. In November, consumer prices remained constant, while annual inflation declined to 7.32 percent. Unprocessed food prices and clothing prices that increased at a lower rate than seasonal averages were influential in this development. In this period, core inflation indicators followed a downward course.

2. Annual food group inflation receded to 9.77 percent. In November, unprocessed food group inflation decreased due to fresh fruit and vegetable prices and became 12.93 percent. Processed food prices increased by 0.49 percent while the group's annual inflation declined to 7.35 percent. Leading indicators for December suggest that the decline in annual food group inflation will continue.

3. In November, energy prices increased by 0.25 percent, while annual energy inflation rose to 2.68 percent. Energy inflation continues to follow a favorable course, but will increase in December particularly due to sharp increases in LPG and bottled gas prices.

4. In November, services prices increased by 0.35 percent and the group's annual inflation rose to 7.96 percent. Among subcategories, annual inflation increased in rent and other services. Meanwhile, although services inflation remains elevated, seasonally adjusted data indicate a slowdown in the underlying trend. Annual core goods inflation, which has been following a volatile trend for the last two months due to clothing prices, fell to 6.47 percent in November. Similarly, seasonally adjusted data suggest that the group's underlying trend decreased. Accordingly, the underlying trend of core inflation indicators declined in November.

5. In sum, the Committee expects that inflation will continue to fall in the upcoming period but core inflation indicators will remain above the target for a while.

Factors Affecting Inflation

6. Recent data releases suggest that final domestic demand and exports continue to grow moderately. According to third-quarter national income data announced by TurkStat, economic activity increased in line with expectations. Investigating the contributions made by demand components to quarterly growth, it is seen that the highest contribution comes from private demand. Considering the seasonally adjusted data with expenditure approach; private consumption expenditures were higher compared to the second quarter, while private machinery-equipment investments increased mildly. Private construction investments grew robustly in the third quarter as in the previous quarter. In the third quarter, both exports and imports decreased on a quarterly basis, while the balancing between external demand components displayed a more positive outlook compared to the second quarter since the decline in exports was more modest. Thus, the contribution of net exports to quarterly growth became positive for the first time in 2013. The quarterly contributions of public sector and stock change were negative.

7. Data releases suggest that final domestic demand will continue to recover in the fourth quarter. The consumer confidence index, one of the indicators regarding the confidence channel that plays a major role in private consumption demand, increased moderately. Investments display a similar pattern to consumption demand. The expectation for fixed capital investment spending asked in the Business Tendency Survey continued to rise in November –a trend that started in September– thanks to waning global and domestic uncertainties. Thus, private sector investments are expected to increase moderately in the last quarter of the year.

8. Survey indicators for October-November suggest that economic activity continues to grow modestly. In fact, both the Business Tendency Survey's past-three-month production question and the PMI index exceeded their third-quarter averages. The BTS' three-month-ahead expectations for both domestic and export markets increased significantly.

9. Recent indicators suggest that exports continue to grow modestly. The non-gold export volume index was down in October from the previous month, but its underlying trend is thought to be following an upward track similar to that of production data. In fact, after prolonged sluggishness, the import demand from the EU, Turkey's leading 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 the upcoming period.

10. Data on 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 limited growth. Accordingly, it is anticipated that excluding the gold trade, the modest improvement in current account deficit will continue.

11. According to seasonally adjusted data, total unemployment rate rose in September 2013 from the previous period, while non-farm unemployment rate declined. However, both the labor participation rate and non-farm employment was down in September from the previous period. Across subcategories of non-farm employment, employment remains weak in the industrial sector, but is slightly increasing in construction and services sectors. Leading indicators suggest that the weakening course of employment may continue in the October period. Yet, global economic uncertainties may remain a constraint to employment growth for the upcoming period.

Monetary Policy and Risks

12. The Committee assessed that final domestic demand and exports continue to grow at a moderate pace and that aggregate demand conditions do not exert an evident downside or upside pressure on inflation. The present policy framework is contributing to the improvement in the current account balance. The Committee stated that the cautious monetary policy stance, the announced macroprudential measures, and weak capital flows will bring down the loan growth rates to more reasonable levels. Accordingly, the moderate decline in the current account deficit excluding gold trade is expected to continue.

13. Inflation is expected to fall further in the forthcoming period. Meanwhile, core inflation indicators are likely to hover above the inflation target for some time. The Committee stated that the cautious monetary stance should be maintained until the inflation outlook is in line with the medium-term targets. The current policy stance is regarded to be appropriate to contain inflationary risks. However, it was also stated caution should be exercised against developments that may worsen the inflation outlook.

14. The Committee underlined the importance of a policy stance where the short-term market rates follow a more predictable and stable course in order to contain the effects of the uncertainty that stems from global monetary policies on the domestic economy. Accordingly, to increase the predictability of short-term rates, the Committee stated that interbank market rates would be ensured to materialize around 7.75 percent, and the weighted average funding

cost of funding would be at or above 6.75 percent. It was also decided that the composition of the liquidity injected to the market would be adjusted accordingly.

15. The Committee made assessments on the reserve options mechanism (ROM). It was stated that the ROM functioned in accordance with its aim and steps might be taken to strengthen its feature as an automatic stabilizer in the upcoming period. Accordingly, it was expressed that reserve option coefficients especially in the last tranches might be gradually increased. The Committee also declared that increases in reserve option coefficients and the FX selling auctions would increase the funding requirement of the financial system. Thus, the effectiveness of the provided interest rate predictability will be reinforced. The Committee has stated that with these developments, the cautious monetary policy stance will continue to contribute to domestic and foreign demand rebalancing, to more plausible growth rates in especially consumer credits and to the decline in inflation.

16. 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.

17. 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.