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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 22 January 2013

Inflation Developments

1. In December, consumer prices were up by 0.38 percent and annual inflation went down to 6.16 percent. Thus, the year-end CPI inflation hit the lowest level of the last 44 years. Unprocessed food prices continued to support the decline in annual consumer inflation. Core inflation indicators remained mild amid cost and demand-side developments.

2. On the food and non-alcoholic beverages front, year-end annual inflation was 3.90 percent, which was significantly lower than past year averages. This was mainly driven by unprocessed food prices, the annual inflation of which went down to -2.78 percent upon falling vegetable prices. Leading indicators point that the favorable trend in unprocessed food prices will reverse in January and the group's annual inflation will register notable increases. As for the processed food group, parallel to the uptrend in domestic wheat prices, bread and cereals group maintains rising prices; whereas annual inflation in items excluding breads and cereals continues to decelerate.

3. Annual services inflation remained at 7 percent. Across subcategories, communication services and rents registered rising inflation rates. However, recording the lowest last-quarter-rise of recent years, restaurants-hotels and transport services exhibited a decline in annual inflation. Both the seasonally-adjusted underlying trend and the diffusion index of the prices of services edged down and pointed that prices of services remained on a mild track.

4. Annual inflation in core goods group followed a flat course compared to the previous month and completed the year with 4.5 percent. The main driver of the deceleration in core goods inflation across the year was durable goods prices, which went up merely by 0.17 percent in 2012. In the forthcoming period, core goods inflation is expected to maintain its decelerating trend due to the prices of clothing and other core goods, which are core goods excluding durables. Seasonally adjusted data show that the relatively mild pace in the underlying trend of core inflation indicators continued despite the rise in December.

5. Overall, the Committee has indicated that inflation may increase slightly in January due to adjustments in tobacco prices, but will resume its downward trend afterwards. Core inflation indicators are expected to continue their downward trend.

Factors Affecting Inflation

6. Data regarding the fourth quarter of 2012 indicated that economic activity is in a trend of recovery. Increase in industrial production partially compensated for the decline in October and production remained above the third-quarter level in the October-November period. The Committee highlighted that annual growth rates continue to display notable fluctuations. In fact, industrial production, which recorded two-digit increases in November on an annual basis, is expected to exhibit a rather minor change in December on an annual basis. Meanwhile, leading indicators point that production will increasingly get stronger in the forthcoming period.

7. Data on production, imports and surveys regarding investment demand, which have been one of the main drivers of the weak course of the final domestic demand recently, signal for a recovery. Data related to consumption demand indicate a mild increase in the private consumption demand. Due to the support of lagged effects of the accommodative monetary policy, the recovery in the final domestic demand is expected to continue in the first quarter. Recent acceleration in loan growth and domestic market orders also support this outlook.

8. Recently released data suggest that despite the weakening global growth, exports continue to increase on the back of market and product diversification. Imports, on the other hand, are expected to slightly accelerate in the forthcoming months due to the rise in domestic demand. However, the Committee estimates that the improvement in the 12-month cumulative current account deficit will continue, albeit at a slower pace.

9. Seasonally adjusted unemployment rate declined upon the rise in non-farm employment in October 2012. Rise in the non-farm employment has mostly been driven by the services sector, while employment in the industrial sector has remained weak recently. Furthermore, the employment expectation data in the Business Tendency Survey and the PMI employment data signal for improvements in employment conditions in the last quarter of 2012. Other leading indicators also signal that mild increases in non-farm employment will continue. However, uncertainties regarding the global economy remain to be critical factors that may restrain employment growth.

Risks and Monetary Policy

10. In the meeting, the Committee has assessed macroeconomic developments and forecasts to appear in the January Inflation Report. It was concluded that there is no major revision in the factors affecting inflation outlook, and thus year-end inflation forecast would be kept at 5.3 percent. It was stated that core inflation indicators are expected to continue their downward trend, yet the impact of increases in administered prices on the pricing behavior will be monitored closely.

11. Recent data confirm that the rebalancing between the domestic and external demand continues as envisaged. Domestic demand follows a moderate pace while exports continue to increase despite weak global activity. Overall, current account deficit continues to decline gradually.

12. The Committee has indicated that the recent credit growth has been faster than envisaged. Developments regarding financial conditions such as rapid capital inflows, improving credit supply conditions, and accommodative monetary policy point to the risk of further acceleration in credit and domestic demand for the forthcoming period, necessitating a cautious stance against macro financial risks. The Committee stated that, in order to contain the risks on financial stability, the proper policy would be to keep interest rates at low levels while continuing with macroprudential measures. Accordingly, it was deemed appropriate to implement a measured tightening through reserve requirements, while delivering a limited downward shift in the interest rate corridor.

13. The Committee indicated that, although global risk perceptions have improved considerably in the recent period, persisting volatility in the cross border capital flows necessitate monetary policy to be flexible on both sides. Ongoing monetary expansion in advanced economies, commitment to maintain this policy until economic indicators improve, and increasing global risk appetite have been the major factors leading to an acceleration in capital flows to emerging markets. Nevertheless, the deleveraging process in advanced economies may impede the recovery in the economic activity and thus slow down the improvement in the budget balances. In fact, despite the steps taken to resolve the problems in the euro area, outlook for credit markets and economic growth remain weak. Meanwhile, uncertainty indices regarding the economic policy in major advanced economies are still at high levels. Therefore, it is likely that the recent improvement in the risk sentiment may reverse course in the forthcoming period. Should such a risk materialize, the Central Bank will take the necessary measures via the flexible policy framework it has developed.

14. Overall, ongoing uncertainties regarding the global economy necessitate the monetary policy to remain flexible in both directions. 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.

15. Accelerating capital inflows and weak global economic outlook may aggravate macro financial risks, should they persist for a while. The recent policies pursued by the Central Bank aim to prevent the build-up of risks arising from long lasting capital inflows. In this respect, recent policies aim at containing rapid credit growth

and appreciation pressures on domestic currency. Macroprudential measures will continue to be taken, should the recent global trends persist and credit growth expectations exceed 15 percent for a long period.

16. On the other hand, aggregate demand and commodity prices may increase faster than expected and monetary policy may normalize in advanced economies, should the measures taken towards the solution of problems regarding the global economy be completed sooner and more decisively than envisaged. Materialization of such a risk would increase pressures on inflation, and thus require a tightening using all policy instruments.

17. Unprocessed food prices continue to pose risks regarding inflation outlook. Developments in unprocessed food prices were the main factors explaining the lower-than-expected inflation in 2012. The possibility of this trend reversing in 2013 poses an upside risk on inflation. The Committee will not respond to volatility in unprocessed food prices, yet will deliver the necessary tightening should this lead to deterioration in pricing behavior.

18. The Committee monitors fiscal policy developments and tax adjustments closely, with regard to their effects on the inflation outlook. Inflation forecasts take the framework outlined in the Medium Term Program as given. In this respect, 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.

19. 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 would ensure the sustainability of the fiscal discipline and reduce the savings deficit would 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, steps towards implementation of the structural reforms envisaged by the Medium Term Program remain to be of utmost importance.