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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 20 August 2013

Inflation Developments

1. In July, consumer prices edged up by 0.31 percent and annual inflation reached 8.88 percent. This uptick was attributed to the base effect besides the recent depreciation in the Turkish lira. Meanwhile, the underlying trend of core inflation indicators exhibited an increase.

2. On the food front, annual inflation edged down to 12.72 percent. As for the unprocessed food group, upon the rising meat prices despite falling prices in fresh fruits and vegetables, annual inflation remained unchanged on a monthly basis. On the other hand, annual processed food inflation receded further due to the favorable course of the prices excluding bread and cereals. Under the current outlook, cumulative increase of unprocessed food prices across 2013 hovers above the averages of past periods. Leading indicators point to a downward course in the group's annual inflation.

3. Energy prices went up owing to the depreciation in the Turkish lira coupled with increasing oil prices. Due to the base effect, the annual energy inflation is envisaged to considerably decline as of August.

4. Prices of services went up by 0.79 percent, and annual services inflation reached 7.97 percent in July, which was attributed to communication and other services. Seasonally adjusted data suggest that the underlying trend of services inflation remained on an upward course in July.

5. Annual inflation in core goods group went up by around 1 percentage point to 4.23 percent in July. The depreciation in the Turkish lira pushed up the annual inflation in durable goods. Meanwhile, annual inflation in other subcategories of core goods remained on a downward track. As a result, the seasonally-adjusted trend of increase in core goods recorded an uptick. Given this outlook of services and core goods, the underlying trend of core inflation indicators trended upwards as well.

6. In sum, while inflation is expected to start falling from August onwards as envisaged, pricing behavior is closely monitored.

Factors Affecting Inflation

7. Recent data suggest that domestic and external demand developments are in line with expectations. In the second quarter, increases in production and imports of consumption and investment goods continued with lower increases compared to the first quarter, while sales of automobiles and credit growth maintained their robust trends. Triggered also by rising exports excluding gold, industrial production maintained a steady trend of increase in the second quarter. On the other hand, uncertainties regarding global economic policies besides the volatility in capital flows fuel the downside risks in the third quarter. Supporting this, indicators of the Business Tendency Survey and PMI in July reveal receding figures compared to the averages of the second quarter.

8. Data regarding foreign trade and the current account balance are in line with expectations. Gradual improvement in the current account deficit, excluding gold trade, continues. The current policy framework, with the additional support from recent macroprudential policies, will continue to improve the current account balance. Accordingly, the deterioration in demand components, which appeared in the first half of the year, is expected to start improving by the third quarter.

9. According to the seasonally adjusted data, non-farm employment remained on a steadily increasing track in the May 2013 period. Nevertheless, the ratio of the non-farm labor force to the working age population increased more, resulting in the total and non-farm unemployment rates to increase compared to the previous period. While the recent rise in non-farm employment was mainly driven by the industrial sector besides the services sector, employment in the construction sector exhibited a decline. Total Employment Expectation, among the CBRT Business Tendency Survey indicators and the PMI Employment Index signal that industrial employment will continue to increase in the third quarter, albeit at a decelerating pace. Yet, uncertainty regarding the global economy remains as a risk factor that may restrain investment and employment growth in the forthcoming period.

Monetary Policy and Risks

10. Recent volatilities in financial markets were discussed in the meeting. Developments regarding global monetary policies since May have been leading to the re-pricing of all financial assets. Lingering uncertainties particularly in the monetary policies of developed economies fuel the volatility in financial markets. In line with these developments, the weight of emerging market assets in global portfolio investments is observed to decrease. Although economic fundamentals are supposed to determine capital movements in the medium and long-term,

uncertainties in monetary policies stemming from developed economies lead to financial fluctuations.

11. The Euro area survived the recession and posted positive growth figures in the second quarter, which is considered to be favorable for the current account balance. Nevertheless, the recently-released data suggest that the global economy has not settled into a stable growth trend yet. Due to the unstable outlook regarding the global economic activity coupled with the uncertainties regarding the monetary policies of developed economies, future capital flows are envisaged to remain volatile. Against this backdrop, the Committee assessed that it is important to maintain the flexibility of the Turkish lira liquidity management. To this end, developments regarding price stability and financial stability will be closely monitored and necessary adjustments will be made in the composition of Turkish lira liquidity provided by the Central Bank.

12. Credit growth rates continue to hover above the reference rate. The recently-weakening capital flows and the recent macroprudential measures are expected to restrain credit growth rates. In such a conjuncture , the Committee assessed that being also supported by the cautious monetary policy stance, credit growth rates would gradually go down to more plausible levels. This gradual slowdown in the credit growth rate will not only improve the current account deficit, but also support financial stability.

13. The high course of unprocessed food prices, the base effect from energy prices and the effects of exchange rate movements led the inflation to high figures as expected. Inflation is expected to start falling from August onwards as envisaged. Yet, in order to contain the adverse impact of the above-target inflation indicators on the pricing behavior, the Committee has decided to strengthen the cautious stance of the monetary policy. The cautious stance will be maintained until the inflation outlook is in line with the medium term targets. In this respect, additional monetary tightening will be implemented whenever needed. In order to increase the effectiveness of the additional monetary tightening, the Committee has decided to raise the overnight lending rate from 7.25 percent to 7.75 percent.

14. 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. 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.

15. 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, implementation of the structural reforms envisaged by the Medium Term Program remains to be of utmost importance.