No: 2013 – 10 **Release Date: 26 February 2013**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 19 February 2013

Inflation Developments

1. In January, consumer prices were up by 1.65 percent and annual inflation increased to 7.31 percent. As also stated in the summary of the previous Monetary Policy Committee (the Committee) Meeting, this is attributed to the tax adjustment in tobacco products and the rise in unprocessed food prices, which added around 1.5 percentage points to annual inflation in January. On the other hand, core inflation indicators and prices of services remained on a relatively mild track.

2. On the food and non-alcoholic beverages front, annual inflation went up to 6.85 percent. Vegetable prices soared by 21.4 percent amid adverse weather conditions in January, pushing the annual unprocessed food inflation considerably upwards. On the other hand, annual processed food inflation decreased. Across subcategories, bread and cereals group maintained rising prices; whereas price increases in other processed food products lost pace in January.

3. Energy prices edged up in January, while the annual energy inflation went down to 11.90 percent with base effects. On the other hand, international oil prices presently remain above the level projected in the January Inflation Report.

4. Annual services inflation remained unchanged on a monthly basis. Annual inflation declined in transport services; contrary to a slight increase in other subcategories of services. However, both the seasonally adjusted underlying trend and the diffusion index of the prices of services edged down and indicated that prices of services remained on a mild track.

5. Inflation in core goods group edged down in January. As the seasonal sale in the clothing group in the last two months lagged behind that in the previous year, the annual rate of price increase trended upwards. Meanwhile, annual inflation in subcategories excluding clothing maintained their downward trend.

6. Consequently, the Committee has indicated that core inflation indicators are expected to follow a mild course and inflation will continue to fall despite the recent increase in oil prices.

Factors Affecting Inflation

7. Industrial production data regarding the last quarter of 2012 suggests a weaker-than-expected economic activity. The Committee indicated that the recovery in the domestic demand has not been reflected in the industrial production data yet, which may be explained by the ongoing inventory depletion. In fact, surveys regarding the industrial sector point to a fall in the stocks of final products during the last quarter.

8. Data pertaining to the last quarter of 2012 on the current account and foreign trade confirm that the rebalancing between the domestic and external demand continues as envisaged. In spite of the sluggish global growth, exports continued to increase owing to market and product diversification. Meanwhile, the increase in imports maintained its mild course. Accordingly, the 12-month cumulative current account deficit continued to decline.

9. The Committee highlighted that domestic demand and imports may gradually gain momentum as of the first quarter of 2013. Recently-released data on automobile sales, foreign trade, credits, consumer confidence index and expectations for orders obtained from surveys have pointed to a remarkable uptick in domestic demand stemming both from consumption and investment demand.

10. Seasonally adjusted employment continued to increase in November 2012. However, unemployment increased slightly due to higher labor force participation rates. The recent increase in non-farm employment was triggered mainly by the services sector, while employment in the industrial sector remained weak amid the developments in production. A similar pattern is expected to prevail in December, while employment growth is expected to be more broad- based starting from early 2013. Nevertheless, uncertainties regarding the global economy may restrain employment and investment growth in the forthcoming period.

Monetary Policy and Risks

11. The Committee has assessed that the expansionary impact of the monetary stimulus provided during the second half of 2012 will be visible in the forthcoming period. In this respect, it is expected that final domestic demand will increase markedly in the first quarter, and the recovery will be reflected in the production more strongly starting from the second quarter.

12. The Committee has indicated that low level of capacity utilization rate contains the upside pressures on inflation, notwithstanding the revival in economic activity. Accordingly, inflation is expected to continue to fall despite the elevated levels of oil prices. Core inflation indicators are also expected to follow a mild course.

In the meantime, the impact of increases in administered prices on the pricing behavior will be monitored closely.

13. The Committee indicated that credit growth displayed a significant acceleration in the past three months due to strong capital inflows. Moreover, the Committee stated that capital inflows during this period increased the appreciation pressures on the domestic currency. Therefore, 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.

14. The Committee has indicated that cutting the lower bound of the interest rate corridor will limit the appreciation pressures on the Turkish lira and thus contain macro financial risks. Moreover, improving risk appetite, declining interest rates in emerging markets, and more effective implementation of the Reserve Options Mechanism allows a downward adjustment in the upper bound of the interest rate corridor. Meanwhile, it would be useful to increase reserve requirements in order to bring credit growth to more reasonable levels. In light of these assessments, it was deemed appropriate to implement a measured tightening through reserve requirements, while delivering a limited downward shift in the interest rate corridor.

15. 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 and increasing global risk appetite have been leading to strong capital flows towards 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, and debt sustainability concerns continue. Meanwhile, uncertainty indices regarding the economic policy in major advanced economies are still at high levels. In light of these assessments, the Committee stated that ongoing uncertainties regarding the global economy necessitate the monetary policy to remain flexible in both directions. Therefore, the impact of the measures taken regarding credit, domestic demand, and inflation expectations will be monitored closely and the funding amount will be adjusted in either direction, as needed.

16. The Committee monitors fiscal policy developments and tax adjustments closely, with regard to their effects on the inflation outlook. In the setting of monetary policy, the framework outlined in the Medium Term Program is taken 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.

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 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.