

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 23 October 2013

Inflation Developments

1. In September, consumer prices edged up by 0.76 percent and annual inflation receded to 7.88 percent, which was attributed to unprocessed food and energy prices. Due to the depreciation of the Turkish lira, core inflation indicators remained on an increasing track.
2. Annual inflation in the food group went down to 8.73 percent. The unprocessed food group saw a decline by 3.85 percentage points to 9.02 percent in annual inflation due to falling prices of fresh fruits and vegetables. On the processed food front, annual inflation reached 8.48 percent despite the decelerating course of the prices of bread and cereals.
3. Energy prices went up by 1.38 percent owing to the depreciation of the Turkish lira. Nevertheless, the annual energy inflation declined owing to the base effect. Due to the elimination of the effect of public price adjustments in October in the same period of the previous year, the annual energy inflation is envisioned to decline further.
4. Prices of services increased by 0.90 percent, and the annual services inflation edged up to 8.22 percent in September. Seasonally adjusted data suggest that the underlying trend of services inflation remained on a high track as well. Annual inflation in the core goods group climbed to 5.74 percent in September. The effects of the exchange-rate pass-through are particularly visible in prices of durable goods. On account of this outlook for services and core goods, the underlying trend of an increase in core inflation indicators followed an upward course.
5. In sum, inflation is expected to fall further in the upcoming period; yet, core inflation indicators are foreseen to remain above the target for a while due to recent exchange rate developments.

Factors Affecting Inflation

6. Recently-released data indicate that final domestic demand exhibited a mild recovery in the third quarter. Consumption goods displayed a decrease in the July-August period compared to the second quarter, while available data regarding the imports of consumption goods and the sales of white goods and automobiles indicate an increase in consumption demand. On the other hand, imports of capital goods and production of capital goods excluding vehicles besides the production of other non-metallic minerals display a sluggish outlook in investments compared to consumption demand.
7. Indicators of the PMI and the Business Tendency Survey reveal a mild recovery across the third quarter. Headline PMI and PMI production indices remained above the second-quarter-levels. Moreover, the three-month-ahead expectation for orders increased due to developments in the domestic and export markets. On the other hand, it should be noted that the consumer confidence index and the firms' expectations of future investments, which have an important role in the private sector consumption and investment demand, display an unfavorable outlook.
8. The industrial production index, which increased in July, plunged in August and therefore remained below the average of the previous quarter in the July-August period. Figures pertaining to August are considered to fail to fully reflect the underlying trend due to the religious holiday. Thus, it is assessed that the seasonally and calendar-adjusted industrial production data should be handled cautiously.
9. Recently data suggest that exports continue to grow at a moderate pace. The exports volume index excluding gold recorded a mild increase in the July-August period compared to the average of the previous quarter. The import demand from the Euro area, which is the leading trade partner, has recently exhibited a recovery following a protracted sluggish course. Moreover, PMI indicators reveal a recovery on a global scale. Therefore, external demand conditions are expected to support exports in the upcoming period.
10. Data regarding foreign trade and the current account balance are in line with expectations. In 12-month cumulative terms, imports excluding gold follow a flat course, while exports excluding gold remain on a mild increasing track. Against this background, in spite of the expected increase in the annual cumulative current account deficit due to the base effect from the gold trade in the short term, it is anticipated that gradual improvement in the current account balance excluding gold trade will continue.

11. Due to the slowdown in non-farm employment, seasonally-adjusted unemployment rates displayed an increase in the July 2013 period. Most of the subcategories, primarily the construction sector employment, posted a decline in this period. The PMI employment index and the data regarding employment expectation signal that the decline in employment may lose pace from September. In addition, 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

12. The Committee assessed the medium term projections prepared for the October Inflation Report. It is stated that annual consumer inflation in the third quarter of 2013 realized above the July forecasts due to a weaker Turkish lira and higher unprocessed food prices. Exchange rate developments affect core inflation via prices of core goods. Overall, given the assumptions underlying the inflation forecasts and external conditions, the end-2013 inflation forecast was revised upwards mainly on account of the developments in the exchange rate, oil prices and output gap. These developments are expected to be temporary and have a more limited effect on end-2014 inflation.

13. Inflation is expected to fall further in the forthcoming period. However, core inflation indicators are likely to hover above the inflation target for some time and the impact of these developments on pricing behavior is closely monitored. The Committee has indicated that it will maintain the cautious monetary policy stance and continue implementing additional monetary tightening at the appropriate frequency until the medium term inflation outlook is in line with the medium term targets.

14. Recent data suggest that final domestic demand and exports continue to grow at a moderate pace. The present policy framework is contributing to the improvement in the current account balance. The cautious monetary policy stance, the macroprudential measures undertaken and weak capital flows will gradually bring down the loan growth rates to more reasonable levels. Accordingly, a gradual decline in the current account deficit excluding the gold trade is expected to continue.

15. Financial markets have recently exhibited increased uncertainty mainly stemming from global monetary policies. This increased uncertainty prompted a re-pricing of all financial assets including exchange rates; and the weight of emerging economies in global portfolio investments posted a decline. Against this background, monetary policy adopted a cautious stance with a view to balance macro financial risks and to restrain the deterioration in the inflation outlook. In

addition, predictability of the monetary policy was increased in order to restrain the effects of global volatilities on the Turkish economy. The Committee has stated that the rise in the predictability of the monetary policy will continue gradually in the forthcoming period.

16. In the case of uncertainties regarding global monetary policies alleviating in the upcoming months, both advanced and emerging economies might be favorably affected. In that case, capital flows to emerging economies are likely to re-accelerate. The Committee has indicated that materialization of such a scenario may prompt the Central Bank to take steps towards accumulating foreign exchange reserves.
17. On the other hand, in the case of aggravation of uncertainties regarding global monetary policies, there may be consequences on global liquidity, capital flows and the pricing of financial assets. In that case, capital flows to emerging economies are likely to remain weak, which may pose a risk to the inflation outlook. The Committee has stated that in the materialization of such a scenario, the Central Bank may start implementing additional monetary tightening for longer periods to enhance price stability.
18. Food and energy prices are among other factors to pose risks to inflation forecasts. The correction in the unprocessed food prices remained below expectations in the third quarter. Thus, unprocessed food prices, which followed a high course in the first three quarters in comparison with past averages, pose an upside risk to the inflation outlook. Energy prices are assumed to preserve the rather favorable course compared to recent years in the rest of the year. Nevertheless, cumulative effects of the depreciation of the Turkish lira and the international oil price developments pose an upside risk on administered energy prices, albeit limited.
19. 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.
20. 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.