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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 18 October 2012

Inflation Developments

1. In September, consumer prices were up by 1.03 percent and annual inflation climbed to 9.19 percent mainly owing to energy and unprocessed food prices. Core inflation indicators remained on a favorable track. Effects of the hikes in administered prices and tax adjustments were partially seen in September, whereas, the greater part thereof will be evident in October.

2. On the food and non-alcoholic beverages front, annual inflation went up to 10.39 percent. Despite pacing down, seasonally adjusted unprocessed food prices continued to rise in September, pushing the group's annual inflation upwards. However, leading indicators point out that in October annual unprocessed food inflation will plummet due to vegetable prices. As for the processed food group, bread and cereals group prices registered increases, and the rise in wheat prices also reflected on other cereals excluding bread as well. Owing to the base effect, annual processed food inflation continued to taper off in this period; while leading indicators suggest that the trend of high-rated monthly increase in processed food prices may continue in October as well.

3. Energy prices went up by 2.43 percent in September parallel to the rise in fuel and bottled gas prices, which was due to soaring oil prices. This upsurge was also attributed to the raised amount of lump sum special consumption tax on fueloil. However, as the tax arrangement was enforced on September 22, the greater part of the mentioned effect on inflation will be seen in October inflation. Energy prices will soar in October due to the adjustment in natural gas and electricity tariffs as well. These hikes and tax arrangements are projected to have a direct effect of 0.8 percentage points on annual inflation in October.

4. On the services front, annual inflation has been flat since May. Annual inflation increased in restaurant-hotel and communication services, yet declined in transport services and rents in September. Upon the arrangement introduced to university tuition rates, prices of education services posted a monthly decline by 1.19 percent in this period. In September, the diffusion index of the prices of services edged up; however the underlying trend of seasonally-adjusted prices remained on a mild track.

5. Annual inflation in core goods group fell by 1 percentage point in September. Annual inflation in all core goods excluding the clothing group recorded decreases. The decline particularly in durable goods inflation is worth noting.

6. As a result, parallel to the support given by aggregate demand conditions to inflation and the favorable course of cost factors, the slowdown in the underlying trend of core inflation indicators continued. The favorable course of unprocessed

food prices compared to past years will also bolster the downtrend in annual inflation in the short term. Against this background, the Monetary Policy Committee (the Committee) expects the fall in inflation to become more evident during the last quarter of the year.

Factors Affecting Inflation

7. Final domestic demand follows a moderate pace. The sharp fall in industrial production in August can be attributed to sector-specific day-offs other than official holidays in some manufacturing sectors. In this context, the Committee assessed that the August production data are consistent with the mild growth outlook.

8. Recent data releases point to a modest rise in economic activity in the third quarter. Sales of automobile and light commercial vehicles posted a pronounced increase in the third quarter, while those of heavy commercial vehicles exhibited a weaker quarterly outlook despite the increase in September. Sales of white goods displayed a virtually flat course, whereas CNBC-e consumption index suggests a limited rise on a quarterly basis. Driven both by domestic and external market orders, three-month ahead expectations for orders of the manufacturing industry firms have increased for the last three months, while the capacity utilization rate remained flat. On the other hand, the Committee stated that the deceleration in consumer and investor confidence and the investment tendency data in the third quarter posed a downside risk on the economic activity.

9. The rebalancing between the domestic and external demand continues as envisaged. While imports continue to decline on an annual basis upon relative price movements besides the slowdown in credit growth, exports continue to increase despite the weakening global outlook. Overall, aggregate demand conditions support disinflation and 12-month cumulative current account deficit continues to decline gradually.

10. Unemployment rate went up due to the decline in non-farm employment in July, which is attributed to the construction and services sectors. Having exhibited a poor outlook since the April period, employment in the industrial sector remained flat in this period as well. Leading indicators for the industrial employment signal for a deceleration in the pace of employment in the third quarter, while other indicators for the labor market point to a stable outlook in general, albeit a slight deterioration in the August-September period. Nevertheless, uncertainties regarding the global economy remain to be critical factors that may restrain the rise in employment.

Monetary Policy and Risks

11. The Committee has stated that increasing the reserve option coefficients and narrowing the interest rate corridor by a measured amount would support financial stability. If deemed necessary, a measured step in the same direction may be taken in the forthcoming period.
12. The meeting also included an assessment of inflation forecasts to prepared for the Inflation Report. The Committee expects the fall in inflation to become more

evident during the last quarter of the year. However, a cautious stance regarding pricing behavior is warranted given that inflation will stay above the target rate for some time due to recent increases in administered and energy prices.

13. Although the risk appetite has improved due to recent developments in financial markets, ongoing uncertainties regarding the global economy necessitate the monetary policy to remain flexible on both sides. Uncertainties persist regarding the deleveraging in public, household, and bank balance sheets. The protracted nature of the global recovery has been prompting the extension of quantitative easing packages across advances economies. Despite the steps taken for the resolution of problems regarding the Euro Area, risk appetite remains highly sensitive to any new developments due to ongoing fragilities in the financial system, elevated levels of sovereign borrowing costs across peripheral economies, and weakening growth outlook. Therefore, it is highly likely that short term capital inflows will continue to be volatile in the forthcoming period. Under these conditions, it is important to preserve the flexibility of monetary policy in either direction. 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.
14. Measures taken by the advanced economies during the third quarter of 2012 have eased the tail risks and alleviated the fluctuations in the global financial system. However, there are still uncertainties regarding the implementation of policy measures. It should be noted that the Central Bank of the Republic of Turkey has adequate tools at its disposal to use as needed under this uncertain environment.
15. A prolonged weakness in global economic growth may prompt central banks of developed economies to sustain their monetary easing packages. Extension of the duration of new packages would feed into macro financial risks for emerging economies like Turkey. In such a case a resurge in short term capital inflows may slow down the rebalancing process through rapid credit growth and appreciation pressures on domestic currency. Should such a risk materialize, the Committee may keep short-term rates at low levels while tightening through macroprudential tools such as reserve requirements. Moreover, the automatic stabilizer nature of the Reserve Option Mechanism will support financial stability.
16. Quantitative easing policies by advanced economies also pose risks regarding commodity prices. However, upside risks on inflation could be contained under such a case, as periods of quantitative easing typically coincide with a weakening in the global economy. However, the Committee will take the necessary tightening measures, should the increase in commodity prices prove persistent and consequently lead to a deterioration in the pricing behavior.
17. On the other hand, aggregate demand and commodity prices may increase faster than expected, 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 possibly require a tightening using

all policy instruments, as it would mean increased pressures on the medium-term inflation outlook.

18. Unprocessed food price developments may lead to a more favorable inflation outlook at the end of 2012 than predicted. Despite the favorable course of leading indicators, a rather cautious approach was adopted, assuming that the rate of increase in unprocessed food prices will be close to the past years' average. Year-end inflation may be lower than projected in the baseline scenario of the October Inflation Report, should unprocessed food prices display a more favorable course than envisaged.
19. The Committee monitors fiscal policy developments closely while formulating monetary policy. Forecasts presented in the baseline scenario 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.
20. Prudent fiscal policy is crucial for preserving the resilience of our economy against existing global uncertainties. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the savings deficit would support the relative improvement of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium-term. This will also provide more flexibility for monetary policy and contribute to social welfare by keeping interest rates of long-term government securities 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.