No: 2011 – 62 **29 December 2011**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: December 22, 2011

Inflation Developments

1. In November, consumer prices were up 1.73 percent and annual inflation rose by 1.8 percentage points to 9.48 percent. The contribution of food prices to annual inflation increased significantly amid the reversing base effects from unprocessed food prices. Core goods inflation continued to rise parallel to the exchange rate movements. While the prices of services maintained a relatively moderate course, changes in administered prices continued to feed into inflation in November.

2. The Monetary Policy Committee (the Committee) noted that inflation would increase in December due to the base effects from unprocessed food prices. Prices of food and alcoholic beverages increased by 3.27 percent in November, and annual inflation in this group went up by 5.4 percentage points to 7.11 percent. As also stated in the Summary of the November Meeting, this rise mainly stems from the base effect from unprocessed food prices. However, it should be also noted that in the unprocessed food group, prices of fruits and vegetables posted larger increases than the previous periods. Moreover, annual inflation in processed food mounted to 9.44 percent owing to the cost factors. Annual food inflation is projected to surge in December owing to unprocessed food prices.

3. Administered prices went up due to the adjustments in energy prices and tax hikes especially in tobacco products in October. As foreseen, these tax adjustments were influential also in November and contributed to annual inflation by 0.2 percentage points. Hence, the total contribution of adjustments in administered prices to annual inflation became approximately 1.6 percentage points within the last two months.

4. Prices of services rose by 0.37 percent in November, and annual services inflation remained unchanged. Despite the rise in annual rate of increase in the prices of services excluding transport and catering, seasonally adjusted price and diffusion indices indicate that the benign trend is maintained in the prices of services.

5. Annual core goods inflation rose approximately by 1 percentage point to 9.8 percent in November. Pass-through from depreciation of the Turkish lira is still affecting the prices of durable goods. Meanwhile, amid the hikes in import duties on textiles and ready-wear, seasonally adjusted clothing inflation went up in this period. Thus, core inflation indicators displayed an increase both on an annual basis and in seasonally adjusted monthly terms in November.

Factors Affecting Inflation

6. The Committee assessed that economic activity was robust and underlined the necessity to contain domestic demand considering the inflation outlook. Recent indicators signal that the economic activity remains robust in the last quarter as well. While industrial production surged in October, capacity utilization rate maintained its uptrend in November. Meanwhile, labor market developments point to a strong course in non-industrial sectors as well. Unemployment rates continued to fall in line with non-farm employment developments in September. Moreover, sectors like construction and services, relatively less sensitive sectors to external developments, stood out with their high contributions to the rise in employment.

7. The Committee highlighted the robust course of the demand for goods and services, mostly determined by current income, therefore employment conditions, notwithstanding the signals for a slowdown in durables and investment goods, which are more sensitive to exchange rates and financing conditions. Meanwhile, the additional measures taken towards monetary tightening in October coupled with the ongoing global problems are expected to contain credit facility and the domestic-demand-side pressures. In fact, the slowdown in the consumer loan growth is becoming more pronounced.

8. External demand remains weak. Amid the recently aggravated problems regarding the euro area, medium-term growth forecasts for the global economy have been revised downwards. The global outlook for 2012 points to a slowdown in almost all economies. Thus, the Committee underlined that global problems would continue to restrain foreign demand notwithstanding the improved market diversification and enhanced competitiveness provided by exchange rate movements. It was also stated that while foreign demand remains subdued, containing effects of the ongoing slowdown in domestic demand and the cumulative depreciation in the Turkish lira on imports has become obvious. In this context, it was highlighted that the improvement in the current account balance would become more pronounced through the end of the year.

Risks and Monetary Policy

9. Data on the third quarter of the year confirm that the rebalancing between the domestic and external demand is ongoing as envisaged. Final domestic demand

is decelerating and the contribution of net external demand to growth is increasing. Accordingly, the improvement in the current account balance is becoming more pronounced. The Committee has indicated that the correction in the current account balance is more evident in seasonally adjusted data and this trend will be reflected shortly in the annualized series.

10. The Central Bank delivered a strong tightening in October in order to prevent the potential second round effects of 2011 year-end inflation that will exceed the target significantly. Shorter end of the market yield curve has shifted upwards suggesting that monetary stance is tight. Moreover, loan rates have increased after the tightening. Although recent data releases suggest that the economic activity is stronger than expected, domestic demand is expected to follow a moderate path due to monetary tightening. In fact, the slowdown in the consumer loan growth is becoming more pronounced. Therefore, the Committee expects second round effects of the temporary price movements to remain contained and inflation to fall gradually throughout 2012, converging to 5 percent target during the final months of the year.

11. The Committee believes that medium term inflationary pressures are contained through the measures taken; yet the pricing behavior and inflation expectations should be closely monitored given the current high levels of inflation. Inflation is likely to stay at high levels during the first few months of 2012 due to exchange rate pass-through, administered price hikes and adverse developments in unprocessed food prices. In this respect, the Committee has indicated that tight monetary policy should be maintained for a while in order to keep inflation outlook consistent with the medium term targets. However, given the prevailing uncertainties regarding global economy, it would be appropriate to preserve the flexibility of monetary policy. Therefore, the impact of the measures undertaken on credit, domestic demand, and inflation expectations will be monitored closely and the amount of Turkish lira funding via one-week repo auctions will be timely adjusted on either direction, if needed.

12. Moreover, the Committee has determined the main components of the “Monetary and Exchange Rate Policy in 2012” document, which was published on Tuesday, December 27. The Committee has indicated that the flexibility provided by the interest rate corridor system has been alleviating the adverse effects of the capital flow volatility on the domestic economy. However, the Committee has also noted that it would be useful to increase the predictability, conditional on the developments in the global economy. Accordingly, the Committee has decided to announce some arrangements regarding the Turkish lira and foreign exchange liquidity management prior to the press meeting on December 27.

13. In line with the strategy formulated at the interim meeting of August 4, 2011, the Committee will continue to monitor global developments closely and take the

needed measures promptly to maintain the stability in the domestic financial markets.

14. Monetary policy will continue to focus on price stability while preserving financial stability as a supplementary objective. To this end, the impact of the macroprudential measures taken by the CBRT and other institutions on the inflation outlook will be assessed carefully. Maintenance of the fiscal discipline and strengthening the commitment to structural reform agenda in the medium term would support the relative improvement of Turkey's sovereign risk, and thus facilitate macroeconomic and price stability. Sustaining the fiscal discipline will also provide more flexibility for monetary policy and support the social welfare by keeping long term interest rates permanently at low levels. In this respect, timely implementation of the structural reforms envisaged by the new Medium Term Program remains to be of utmost importance.