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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 18 February 2014

Inflation Developments

1. In January, consumer prices increased by 1.98 percent, and annual inflation reached 7.75 percent. Food prices, tax adjustments and exchange rate movements were influential in this rise and core inflation indicators recorded an increase due to core goods. Meanwhile, services inflation maintained its relatively mild course.

2. Annual food group inflation climbed to 10.89 percent. In January, not only fresh fruits and vegetables but also other products registered price hikes. This resulted in increased annual unprocessed food inflation despite the high base from the previous year. Meanwhile, upon price increases that spread across the group, processed food prices were up by 1.42 percent and the group's annual inflation reached 8 percent.

3. In January, despite the fall in international oil prices, energy prices increased owing to the rise in domestic fuel prices amid the depreciation of the Turkish lira. Meanwhile, in the alcoholic beverages and tobacco products group, SCT adjustments introduced pushed the tobacco products' prices up by 7.4 percent.

4. Prices of services edged up by 0.93 percent, and the group's annual inflation maintained its level around 8 percent. Seasonally adjusted data pointed to a limited rise in the underlying trend of services inflation in this period. Meanwhile, annual core goods inflation increased by about 1 percentage points to 7.12 percent. This was mainly driven by the surging prices of durable goods on the reverberations of the depreciation in the Turkish lira besides the raised SCT on automobiles. On the other hand, annual inflation in the clothing group remained on a downward trend. Core goods prices accelerated as the depreciation in the Turkish lira that started in mid-December has reflected on prices since January.

5. In sum, The Monetary Policy Committee (the Committee) closely monitors the recent deterioration in the inflation outlook and expectations. Inflation is likely to hover above the 5-percent target for some time due to the recent tax adjustments, exchange rate developments and the unfavorable course of food prices.

Factors Affecting Inflation

6. Recent data suggest that final domestic demand continued to increase moderately in the fourth quarter. Following the recent sharp fluctuations, the industrial production index remained steady at its November level in December. Yet, in quarterly terms, industrial production posted a modest quarter-on-quarter increase in the fourth quarter, which is close to the average growth rate seen since early 2012.

7. The moderate trend in private consumption demand continued in the last quarter of the year. Production and imports of consumer goods were up quarter-on-quarter compared to the previous quarter. Despite hovering slightly below the averages of the previous quarter, sales of automobiles and white goods remained elevated throughout the fourth quarter. Meanwhile, investment demand was more favorable in the fourth quarter. Production of capital goods grew moderately quarter-on-quarter in the final quarter. The production of capital goods excluding vehicles, an indicator for the underlying trend, recorded a larger growth than total capital goods. Similarly, imports of capital goods increased as well.

8. Data suggest that exports maintained their modest growth trend in the fourth quarter. In fact, the non-gold export volume index was up in the fourth quarter from the third-quarter average. The global recovery and the robust international import demand that PMI indicators point to have been effective in this increase.

9. The increased domestic uncertainty has caused consumer confidence to slump recently. Meanwhile, automobile sales also slowed dramatically in January. Moreover, loans, particularly consumer loans, have been posting a gradually slower rate of growth. On the other hand, despite some weakening, the investment and employment sentiment in January's Business Tendency Survey (BTS) maintained their moderate levels, while the PMI new order and production indices have no negative outlook. Against this background, the Committee envisages that private domestic final demand may decelerate in the first quarter of 2014.

10. Seasonally adjusted unemployment rates remained unchanged in November 2013. The rise in employment in this period came largely from the services sector, while construction employment increased after a flat performance throughout 2013 and industrial employment remained relatively weak. Leading indicators show no signs of additional worsening for employment and point to a moderate employment growth. In view of the expected slowdown in domestic demand, unemployment appears to be on a slightly upward trend for 2014. A smaller-than-expected global economic recovery and domestic uncertainties may remain constraint to investment and employment growth for the upcoming period.

Monetary Policy and Risks

11. The Committee noted that credit growth has been slowing gradually due to tight monetary policy, macroprudential measures and weak capital flows. Particularly due to macroprudential measures, the growth of consumer loans is expected to slow at a relatively faster pace. Moreover, it is assessed that the recent uncertainty might cause private demand to weaken in the first quarter. Data released for the first quarter of 2014 suggest that private domestic final demand might decelerate.

12. Recent data indicate that exports continue to grow moderately and the non-gold current account balance maintains its improvement trend. Thus, the Committee stated that the recovering external demand and the slowing private domestic final demand will help to increase the positive contribution from net exports to growth over the year. This increase may also contain the negative effects of the decelerating domestic final demand on growth. In addition, the slowdown in consumer loan growth could particularly support the current account rebalancing. Against this background, the Committee expects the current account balance to display a significant improvement in 2014.

13. In the second half of 2013, with the high course of food prices and the external uncertainties that led the Turkish lira to depreciate, inflation increased and core inflation indicators and inflation expectations deteriorated. Recent and lingering external uncertainties coupled with the elevated domestic uncertainties caused additional exchange rate movements, which weighed on the risk of inflation exceeding the target for a protracted period. Moreover, the recent tax adjustments and the persisting unfavorable course of food prices also exacerbated the deterioration in the inflation outlook.

14. The Committee closely monitors the recent deterioration in the inflation outlook and expectations. It is envisaged that factors affecting inflation adversely will keep inflation indicators considerably above the 5-percent target for a while. Against this background, the Committee underlined that it will not tolerate any deterioration in price stability in the medium-term. To this end, the Committee opted for a strong and front-loaded monetary tightening in the interim meeting of 28 January 2014 to prevent deterioration in the inflation expectation and the pricing behavior. The Committee judges that the current policy stance will be enough to anchor inflation expectations. The Committee indicated that tight monetary policy stance will be sustained until there is a significant improvement in the inflation outlook and that the liquidity policy may be tightened further if deemed necessary.

15. 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.

16. Maintaining the cautious stance in fiscal and financial sector policies is critical to the resilience of our economy against current uncertainties. Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improve social welfare by keeping interest rates of long-term government securities permanently at low levels. In this respect, implementation of the structural reforms required by the Medium Term Program remains to be of utmost importance.