

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: January 24, 2012

Inflation Developments

1. In December, consumer prices were up 0.58 percent and annual inflation reached 10.45 percent. As stated in the previous Summary of the Monetary Policy Committee (the Committee) Meeting, annual food inflation surged owing to unprocessed food prices in December. Annual core goods inflation continued to rise due to the lagged effects of the exchange rate pass-through. Meanwhile, the uptrend in core inflation indicators came to a halt owing to the moderate course of the services prices.
2. Prices of food and alcoholic beverages increased by 1.97 percent in December, and annual inflation in this group went up to 12.21 percent. Processed food prices continued to increase, albeit at a slower pace. The sharp rise in the prices of vegetables pushed up the unprocessed good inflation significantly. Thus, quarterly inflation in this group recorded the historically highest increase since the inception of the new CPI index. Coupled with the low base effect, this surge led the contribution of unprocessed food prices to increase by 2.5 percentage points in one quarter.
3. Prices of services rose by 0.29 percent in December, and annual services inflation fell to 6.27 percent due to the high base of the communication services. Annual inflation increased slightly in rents as well as in restaurant and hotel services. Prices of transport services, which have been trending upwards recently amid the depreciation of the Turkish lira, remained flat on monthly terms. Meanwhile, seasonally adjusted prices of services and diffusion index indicate a slowdown in the underlying trend of service inflation.
4. Core goods inflation rose to 10.09 percent in December. Having recorded a decline in clothing and footwear group, annual inflation continued to rise in core goods excluding clothing amid the lagged effects of the depreciation in the Turkish lira. Exchange rate pass-through effects on core goods prices are expected to persist in January, albeit at milder extent.

Factors Affecting Inflation

5. Data releases on the final quarter of 2011 suggest that economic activity decelerated slightly, yet remained robust. Seasonally adjusted industrial production posted a stronger quarterly increase in the October-November period, while the capacity utilization rate trended upwards following a decline in two subsequent quarters. As for the services sector, employment maintains its stable upward trend.
6. Amid the monetary tightening implemented since October and the ongoing global problems, domestic demand is expected to follow a moderate path in the forthcoming period, as suggested by recent trends in consumer loan growth and firms' domestic orders. Moreover, the moderate course of domestic real turnover indices of the manufacturing industry as of the onset of 2011 continued in the October-November period, which indicates that final domestic demand has not accelerated further.
7. External demand remains weak. Amid the recently aggravated problems in 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 highlighted that restrictive effects of the ongoing slowdown in domestic demand and the cumulative depreciation in the Turkish lira on imports has become more evident.
8. Seasonally adjusted non-farm employment posted a decline in October after an extended steady-growth period, interrupting the stable downtrend in unemployment rates. The fall in non-farm employment was driven by the construction and industrial sectors. The Committee has noted that the recent decline in construction employment may continue further, while the industrial sector employment may post an increase in the short-term.

Risks and Monetary Policy

9. Recent data releases 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 rebalancing process and the improvement in the current account deficit would continue in the forthcoming period.

10. The Committee has noted that annual inflation will stay at high levels in the short-term due to accumulated price increases that occurred during the final quarter of 2011. In order to prevent the potential second round effects, the Central Bank has delivered an important monetary tightening since October. Accordingly, domestic demand is expected to follow a moderate path in the forthcoming period, as suggested by recent trends in consumer loan growth and firms' domestic orders. Therefore, the Committee expects second round effects of the temporary price movements to remain contained and disinflation process to accelerate, especially in the final quarter of 2012 with the support of base effects.
11. In light of the past three months' developments, the Committee has assessed the inflation forecast to appear in the January Inflation Report. The committee members indicated that reducing inflation from 10.45 percent to 5 percent target within 12 months would lead to unfavorable fluctuations in economic activity; accordingly, it would be more appropriate to bring inflation back to the target in one and a half year. In other words, the baseline forecast would envisage inflation to reach the target of 5 percent by mid-2013. However, the target might be attained by the end of 2012, should the risk appetite improve markedly in the forthcoming period and the capital flows towards emerging economies re-accelerate, leading to a strong appreciation of the Turkish lira.
12. The Committee has indicated that tight monetary policy stance should be maintained for a while in order to keep inflation outlook consistent with the medium term targets. However, given the prevailing uncertainties regarding the global economy, it would be appropriate to preserve the flexibility of the 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 adjusted in either direction, as needed.
13. Moreover, considering the ongoing improvement in the current account dynamics and the sudden swings in global conditions, the Committee has indicated that intraday foreign exchange sale auctions will be more effective and more consistent with the monetary policy objectives, compared to the regular foreign exchange sale auctions.
14. The Committee noted that inflation will hover at high levels in the short term, and this poses risks regarding second round effects. Although the monetary tightening delivered by the Central Bank since October has reduced the possibility of second round effects, inflation expectations and pricing behavior will be monitored closely and necessary measures will be taken to keep medium-term inflation outlook consistent with the target.
15. According to the Committee members, the probability that the solution of the problems in the euro area may take a more protracted and painful process poses

downside risks regarding global growth and risk appetite. On the other hand, perceptions regarding global economic outlook may turn more favorable than expected, should the measures taken towards the solution completed sooner and more decisively than envisaged. Such a situation, coupled with the ongoing quantitative easing policies pursued by the central banks of advanced economies, may improve risk appetite and re-accelerate capital flows towards emerging economies. Overall, ongoing problems regarding euro area and uncertainties on the effectiveness of measures aimed at solving these problems, suggest that global financial markets will continue to be volatile in the forthcoming period. These conditions necessitate a flexible approach in monetary policy, which utilizes multiple instruments. The Committee will continue to monitor global developments closely and take the required measures promptly.

16. Another risk for the forthcoming period is the uncertainty regarding oil prices. Although weak global outlook dampens commodity prices, rising oil supply problems recently pose upside risks regarding energy prices. Should such a risk materialize, the Committee will not respond to temporary price movements, yet will not tolerate any deterioration in expectations.
17. The Committee monitors fiscal policy developments closely while formulating monetary policy. Current monetary policy takes the Medium Term Program as given and thus assumes that fiscal discipline will be maintained. 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.
18. 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 Central Bank and other institutions on the inflation outlook will be assessed carefully. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the saving 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.