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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 18 March 2014

Inflation Developments

1. In February, consumer prices rose by 0.43 percent, and annual inflation increased by 0.14 percentage points to 7.89 percent. Core inflation indicators displayed an upsurge amid the depreciation in the Turkish lira. Inflation indicators are expected to remain high in the upcoming period due to the unfavorable course of the food prices and the lagged effects of the exchange rate pass-through.

2. Annual food group inflation fell by 0.83 percentage points to 10.05 percent. In February, unprocessed food prices decreased due to vegetable prices. Nevertheless, the unfavorable outlook in unprocessed food prices excluding fresh fruits and vegetables continued, and the annual rate of price increases in this group stood at 24.21 percent. Processed food prices increased by 1.65 percent on a monthly basis amid the price increases that spread across the group, the largest increases being in the bread-cereals item. As a consequence, the group’s annual inflation climbed to 9.42 percent. Meanwhile, the rainfall rate has remained below the seasonal averages in various areas lately, leaving the upside risks to food prices brisk.

3. Prices of services edged up by 0.77 percent, and the group’s annual inflation increased by 0.38 percentage points to 8.34 percent in February. These figures indicated that the services inflation has hit the highest level since the first quarter of 2009. The seasonally adjusted data pointed to a persisting rise in the underlying trend of services inflation in this period as well.

4. Annual core goods inflation increased by 1.28 percentage points to 8.39 percent in February. This was mainly driven by the rising prices of durable goods, particularly automobiles, reflecting the effects of the past depreciation in the Turkish lira. The seasonally-adjusted data pointed to a higher trend in the core goods inflation compared to January. Core inflation indicators registered a similar outlook as well.
5. Against this background, inflation is expected to remain on the rise in the upcoming months, partly reflecting base effects.

Factors Affecting Inflation

6. Industrial production increased remarkably in January compared to December. This increase owes to the recovery from December's weak base as well as to rising export orders and improved export expectations driven by the relative pickup in external demand. Compared with the fourth-quarter average, January's production levels are stronger. Yet, the economic activity is expected to moderate in coming months due to the repercussions of the weak domestic demand on economic activity.

7. In recent months, global and domestic uncertainties and the resulting increase in risk premiums and exchange rates caused consumer confidence to plunge. In addition, the tightening in financial conditions has led to a slowdown in consumer loan growth rates. Available data indicate that sales of appliances and automobiles have been falling recently as well. Thus, the imports and production of durable consumer goods were significantly down in January compared to the previous month and quarter.

8. After following a favorable trend in 2013, investment demand has lost some pace due to recent developments. Expectations for fixed capital investment fell to the lowest level since 2010, while the production of capital goods excluding vehicles, an indicator for the underlying trend of investments, dropped markedly month-on-month in January. Similarly, sales of commercial vehicles slowed down.

9. Recent data show that exports continued to grow in the first quarter of 2014. The export volume index was up in January from both December and the fourth-quarter average. With the support of the global recovery, the robust international import demand, and the Turkish lira depreciation, exports are expected to make a positive contribution to growth in the upcoming period.

10. In sum, recent data releases indicate that final domestic demand will lose momentum, whereas exports will limit the impact of this slowdown on growth. Against this background, the Committee expects the rebalancing to continue and the current account deficit to improve substantially in 2014.

11. In seasonally adjusted terms, total and non-farm unemployment rates were down in December 2013 compared to the previous period. This drop in unemployment rates was mostly driven by the upsurge in non-farm employment. Employment basically increased across services and construction sectors. Industrial employment, on the other hand, increased only slightly and remained relatively weak.

Monetary Policy and Risks

12. The Committee assessed that upward risks on the inflation outlook remain important. Lagged impact of the exchange pass-through continues to exert upside pressures on core inflation, especially through core goods prices. Services inflation and other indicators regarding pricing behavior also suggest that underlying inflation rate is significantly above the target. The strong and frontloaded monetary tightening delivered at the January interim meeting has contained the potential adverse impact of the upside risks on the medium term inflation expectations. Yet, the impact of monetary tightening on inflation will be observed with some lag. In the meanwhile, inflation is expected to increase until June, partly reflecting the base effects. Against this backdrop, inflation expectations and pricing behavior will be closely monitored and the tight monetary policy stance will be maintained until there is a significant improvement in the inflation outlook.

13. Loan growth continues to slow down in response to the tight monetary policy stance, recent macroprudential measures, and weak capital flows. The Committee indicated that the slowdown in loan growth can be mostly attributed to consumer loans and credit cards, noting that Turkish lira commercial loans continue to expand at a robust pace. The pronounced tightening in financial conditions observed in the first quarter suggests that the deceleration trend in loan growth will continue. The Committee members pointed that it will be useful to closely monitor the supply and demand factors driving loan market in the forthcoming period.

14. In line with the developments in loan growth, data regarding the first quarter of 2014 indicate some deceleration in private final domestic demand. Meanwhile, with the help of the recovery in foreign demand, net exports are expected to contribute positively to economic growth. The Committee expects that such a demand composition will contain upside inflationary pressures and lead to a significant improvement in the current account deficit in 2014.

15. The Committee stated that despite the moderate expansion in the economic activity, consumption and investment indicators show some relative weakening. The Committee members indicated that the weakening in demand indicators has not been significantly reflected in the economic activity at this point. However, as indicated in one of the risk scenarios of the Inflation Report, the risk of a marked slowdown in the economic activity through the confidence and balance sheet channels, caused by the possible persistence of existing uncertainties and elevated risk premiums, should not be overlooked. It was reminded that the Central Bank has many tools to

implement countercyclical policy, should such a risk materialize. In this respect reserve requirements, reserve option mechanism and liquidity policies may be utilized, if needed.

16. The Committee has also evaluated the possibility of paying interest to the portion of reserve requirements held in Turkish liras, in the context of the normalization of monetary policy. It was stated that, such a measure could be considered at a future date if deemed necessary. Moreover, implications of paying partial interest to reserve requirements were assessed in different dimensions, with regard to its interaction with the reserve option mechanism. In light of these assessments, it was indicated that any decision regarding the payment of partial interest to reserve requirements to be implemented in the future should be measured and limited.

17. The Committee monitors fiscal policy developments and tax adjustments closely with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption 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.

18. 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 at low levels. In this respect, implementation of the structural reforms required by the Medium Term Program remains to be of utmost importance.