No: 2012 – 56 **Release date: 27 November 2012**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING
Meeting Date: 20 November 2012

Inflation Developments

1. In October, consumer prices were up by 1.96 percent and annual inflation went down to 7.80 percent mainly owing to unprocessed food prices. Core inflation indicators continued with a downward course amid cost and demand-side developments, while prices of services remained mild. Hikes in the SCT (Special Consumption Tax) rates besides natural gas and electricity tariffs are estimated to add around 1 to 1.1 percentage points to the annual inflation.

2. On the food and non-alcoholic beverages front, annual inflation went down to 7.87 percent. Following the upward trend in the third quarter, seasonally adjusted unprocessed food prices displayed a decline in October. Due to flat course of vegetable prices, which soared in October in past years, annual unprocessed food inflation decreased by 5.5 percentage points to 5.35 percent. Leading indicators point that annual unprocessed food inflation will fall notably in November as well. As for the processed foods, bread and cereals group prices continued to register increases, amid rising wheat prices. Processed food prices excluding breads and cereals also accelerated in October. Consequently, a rise in annual processed food inflation is registered.

3. Hikes in the natural gas and electricity tariffs coupled with tax adjustments in fuel oil led the annual energy inflation to climb to 15 percent.

4. On the services front, annual inflation edged up in October. This rise was driven by the increases in the prices of communication services. In the services group excluding communication, annual inflation decreased in October as it did in September. In October, the underlying trend of seasonally-adjusted prices remained on a mild track, while the diffusion index of the prices of services continued to increase.

5. Annual inflation in core goods group fell by 1.32 percentage points to 5.1 percent in October. This decline was apparent in all the main sectors of core goods, and particularly in durable goods. Seasonally adjusted data show that the slowdown in the underlying trend of core inflation indicators continued.

Factors Affecting Inflation

6. Economic activity followed a moderate pace in the third quarter. A sizeable increase was seen in industrial production in September, yet it was attributed to the compensation of the decline led by the divergence in the official and actual

numbers of the days-off in August. In fact, the third-quarter average of the industrial production index increased modestly quarter on quarter.

7. Recent data releases point that economic activity will be stronger in the final quarter compared to the previous quarter. Although sales of automobiles declined on an annual basis in October, they remained above the average of the third quarter. Three-month-ahead expectations for orders of the manufacturing industry firms continued to increase owing to both domestic and external orders. PMI data also displayed a similar trend. Investment tendency still follows a relatively weak course, albeit an increase recently after an extended period. Monetary Policy Committee (Committee) stated that confidence indices are yet to improve and the uncertainties in external financial markets may put a cap on the economic activity.

8. The latest data confirm that the rebalancing between the domestic and external demand continues as envisaged. While imports declined in the third quarter upon the slowdown in credit growth besides the relative price movements, exports continue to increase despite the weakening global outlook. Overall, 12-month cumulative current account deficit continues to decline gradually. On the other hand, the Committee highlighted that the rebalancing process may lose pace due to the pick-up in domestic demand in the last quarter of the year.

9. Employment rate displayed a mild increase on account of the slowdown in economic activity. Despite the rise in non-farm employment in August, there was a limited increase in the seasonally adjusted unemployment rate, owing to an increase in the participation rate. The rise in the non-farm employment rate is attributed to the construction and services sectors. Having exhibited a limited trend of decline since the March period, employment in the industrial sector declined further in August. Despite the recent rise in PMI employment index and industrial production, other leading indicators for the industrial employment signal that employment growth may be limited in the forthcoming period. Moreover, uncertainties regarding the global economy remain to be critical factors that may restrain the employment growth.

Monetary Policy and Risks

10. During the meeting, the Committee assessed the developments regarding price stability and financial stability. In terms of inflation the main variables of interest were aggregate demand outlook, output gap indicators, and cost factors. With regard to macro financial risks, the focus was on credit, current account balance, and real exchange rate developments.

11. According to the Committee, demand side indicators support the downward trend in inflation. Aggregate demand growth has slowed down markedly in the third quarter, mainly driven by developments in final private domestic demand.

Although domestic demand shows some recovery for the final quarter of the year, aggregate demand conditions are still expected to support disinflation.

12. The Committee assessed that cost factors have been contributing to the disinflation as well. With the recent stable course of exchange rates and commodity prices, the accumulated pass-through effects of cost-push factors observed in 2011 have been fading away. Accordingly, core goods inflation has been falling markedly since the beginning of the year. Meanwhile, the underlying trend of services inflation has displayed a benign course.

13. Taking these assessments into account, the Committee expects that year-end inflation will be lower than the forecast presented at the October Inflation Report, owing to the favorable course of unprocessed food prices. However, indirect effects of recent increases in administered and energy prices are closely monitored in terms of medium term inflation outlook.

14. The Committee stated that, as of the third quarter rebalancing in the composition of aggregate demand and thus the improvement in the current account balance continues, and credit volumes keep growing at reasonable rates consistent with the financial stability objectives. On the other hand, it was indicated that the steady real appreciation trend in domestic currency observed since the beginning of the year should be closely monitored. The Committee reminded that, under the current regime, there is no commitment regarding the level of the exchange rate; yet, in terms of macroeconomic and financial stability, it is important to take measures against excessive deviations from economic fundamentals, as needed.

15. The Committee attributes special emphasis on credit developments under the new policy framework. Given the weak outlook for global demand, keeping the rate of credit growth at moderate levels is especially important for ensuring that both the level and the composition of the aggregate demand move towards desired direction. In this context, it was underlined that credit growth rates not exceeding 15 percent annually would support both the price and financial stability.

16. The Committee stated that improved risk appetite towards Turkish economy provided room for a limited hike in reserve option coefficients. It was indicated that both the improved risk appetite and the adoption of reserve option mechanism have eased the need for a wide interest rate corridor. Moreover, the moderate pace of commercial loan growth has allowed for a measured cut in the upper bound of the corridor. The Committee has therefore stated that increasing the reserve option coefficients and narrowing the interest rate corridor by a measured amount would support financial stability.

17. The Committee indicated that ongoing uncertainties regarding the global economy necessitate the monetary policy to remain flexible in both directions. 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.

18. In light of these assessments it was stated that, if deemed necessary for financial stability, a measured cut may be considered in the policy rate and the overnight borrowing rate in the forthcoming period.

19. The Committee monitors fiscal policy developments closely while formulating monetary policy. Current projections for price stability and financial stability outlook take the framework outlined in the Medium Term Program as given. In this respect, it is assumed that in the forthcoming period 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.