No: 2012 – 62 **Release date: 25 December 2012**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 18 December 2012

Inflation Developments

1. In November, consumer prices were up by 0.38 percent and annual inflation went down to 6.37 percent mainly owing to unprocessed food prices. Core inflation indicators continued with a downward course amid cost and demand-side developments, while the prices of services remained mild.

2. On the food and non-alcoholic beverages front, annual inflation went down by 3.5 percentage points to 4.32 percent. Following an upward trend in the third quarter, seasonally adjusted unprocessed food prices displayed a sharp decline in the last two months owing to the prices of fresh fruits and vegetables. Leading indicators point that annual unprocessed food inflation will fall in December as well. As for the processed food group, bread and cereals group prices continued to register increases, amid rising wheat prices. Processed food prices excluding breads and cereals also accelerated in the last two months. Nevertheless, annual processed food inflation went down to 9.13 percent upon the base effect. As for the energy group, annual inflation remains high with 14.5 percent, notwithstanding a slight fall in November.

3. On the services front, annual inflation remained at 7 percent. In November, communication services and rents saw increases; while transport and other services recorded a decline in annual inflation. Both the underlying trend of seasonally-adjusted prices and the diffusion index of the prices of services remained on a mild track.

4. Annual inflation in core goods group maintains its decelerating trend. In contrast to the fall in other subgroups, annual inflation went up in the clothing group in November. Having posted an evident fall, prices in durable goods went back to the levels of 2011. Seasonally adjusted data show that the relative slow pace in the underlying trend of core inflation indicators continued.

5. Consequently, the Committee (the Monetary Policy Committee) projects that the decline in inflation will continue in the short term with the support of favorable unprocessed food prices.

Factors Affecting Inflation

6. The GDP data regarding the third quarter of 2012 confirmed that economic activity followed a moderate course, albeit at a slower pace. Final domestic demand edged down upon the plunge in private investment demand. On the other hand, while exports of goods and services maintained an upward trend, import demand fell, and accordingly net exports remained as the main contributor to growth. When the fall in the final domestic demand is jointly evaluated with the rise in export demand, a sustained balancing process in the economy is apparent.

7. The Committee assessed that the industrial production index recorded a month-on-month decline in October, yet this did not completely reflect the underlying trend of economic activity in the last quarter. This relies on the fact that the divergence in the official and actual numbers of the days-off leads to a fluctuating course in production. Moreover, increases in the expectations for orders of the manufacturing industry besides the PMI entail positive signals for the course of economic activity in the upcoming period. Confidence indices and loan growth also support this outlook.

8. Recently released data suggest that despite the weakening global growth, exports continue to increase on the back of market and product diversification. Imports, on the other hand, are expected to slightly accelerate in the forthcoming months due to the rise in domestic demand. However, the Committee estimates that the improvement in the 12-month cumulative current account deficit will continue, albeit at a slower pace.

9. Seasonally adjusted aggregate and non-farm unemployment rate displayed an increase in September 2012 compared to the previous period. Growth in labor participation rates overshot employment in this period, which led to a rise in unemployment rates. Non-farm employment rate increased due to the construction and services sectors, while employment in the industrial sector continued to decline. Having decreased beyond expectations in October, industrial production is estimated to increase significantly in November. Furthermore, the employment expectation data in the Business Tendency Survey and the PMI employment stand at an optimistic level in November. Other leading indicators signal that mild increases in non-farm employment will continue. However, uncertainties regarding the global economy remain to be critical factors that may restrain the employment growth.

Risks and Monetary Policy

10. Recent data show that both the level and composition of aggregate demand evolves in line with expectations. The rebalancing between the domestic and external demand continues as envisaged. Domestic demand follows a moderate pace while exports continue to increase despite weakening global activity. Overall, aggregate demand conditions support disinflation and current account deficit continues to decline gradually.

11. The Committee expects economic activity to follow a stronger course starting from the last quarter of the year. In fact, confidence indices and credit growth show a marked increase, supported by the accommodative liquidity policies implemented by the Central Bank since mid-year and the relative improvement in the risk appetite. Therefore, the contribution of domestic demand to economic growth is expected to increase in the forthcoming period. However, the Committee has underscored that, credit volume and domestic demand should continue to grow at a sustainable pace in order to preserve price stability and financial stability. Therefore, the impact of the recent significant fall in market interest rates on domestic demand and credit volumes will be monitored closely.

12. The Committee expects that year-end inflation will be significantly lower than the forecast presented in the October Inflation Report, owing to the favorable course of unprocessed food prices. Core inflation indicators are also expected to follow a downward trend in the short-term owing to cost and demand factors. Moreover, inflation expectations display an improving trend. However, indirect effects of recent increases in administered and energy prices are closely monitored in terms of the medium term inflation outlook.

13. The Committee has stated that, in order to contain the risks on financial stability in the face of accelerating capital inflows, the proper policy would be to keep interest rates at low levels while continuing with macroprudential measures. Accordingly, the Committee has indicated that, in order to support financial stability, it would be appropriate to take additional steps using reserve requirements, while delivering a limited cut in the policy rate. In this respect, it was assessed that measured hikes in reserve requirements for foreign currency and in reserve option coefficients for gold would be useful. In the following period, if deemed necessary for financial stability, a measured adjustment in the interest rate corridor might also be considered.

14. Although, risk perceptions towards Turkey have improved in recent months, 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.

15. 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.

16. 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.