

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 21 January 2014

Inflation Developments

1. In December, consumer prices increased by 0.46 percent, while annual inflation rose to 7.40 percent. Energy prices were influential in this development and there was no significant change in the contribution of other main groups to the rise in annual inflation. In this period, core inflation indicators continued to follow a downward course as in November.
2. Annual food group inflation receded to 9.67 percent. In December, annual unprocessed food group inflation remained flat at 12.88 percent, while items other than fresh fruits and vegetables saw widespread price hikes. Processed food prices increased by 0.73 percent due to the bread and cereals group, while the group's annual inflation declined to 7.11 percent. Leading indicators for January suggest that annual food group inflation will remain elevated because of the impact of adverse weather conditions on fresh fruit and vegetable prices.
3. In December, energy prices rose by 2.35 percent mainly owing to sharp increases in LPG and bottled gas prices. Moreover, the recent depreciation of the Turkish lira caused gas and diesel prices to rise. As a result, annual energy inflation recorded the lowest year-end level of the last four years despite rising to 5.15 percent.
4. In December, services prices increased by 0.39 percent, and the group's annual inflation came in at 7.98 percent. The Monetary Policy Committee (the Committee) judged that, despite the favorable course of energy inflation throughout the year, wage increases and the recovery in domestic demand were influential in the rise of services inflation. However, it is noted that recent seasonally adjusted data indicate a slowdown in the underlying trend of services inflation.
5. Meanwhile, annual core goods inflation fell to 6.20 percent in December due to the downward contribution of clothing prices and the waning effects of the Turkish lira depreciation. Seasonally adjusted data also showed that the underlying trend of the group's inflation was on a downward path. However, the resumed depreciation of the Turkish lira as of mid-December and

January's tax adjustments for automobiles may deteriorate the outlook for core goods inflation. In fact, leading indicators have recently pointed to a significant increase in prices of durable goods, especially automobiles.

6. In sum, given that core inflation indicators may show a marked increase in January, it is noted that inflation will remain significantly above the 5 percent target in the short term due to unfavorable food prices as well.

Factors Affecting Inflation

7. Recent data releases suggest that final domestic demand continued to grow moderately in the fourth quarter. The industrial production index compensated the October fall with a rise in November. Although recently there have been sharp volatilities in seasonally adjusted industrial production due to religious holidays, on the whole, the industrial production index posted a modest increase. It should be noted that this trend is almost equal to the average growth rate seen since early 2012.
8. The moderate trend in private consumption demand continued in the last quarter of the year. Production of consumer goods was down while imports of consumer goods were up during October-November compared to the previous quarter. Automobile sales were higher throughout the fourth quarter than the average of the previous quarter. Total sales of automobiles and light commercial vehicles suggest that vehicle sales were virtually flat over the fourth quarter. While down from the previous quarter, sales of appliances remained elevated in the fourth quarter.
9. Indicators for investment demand followed a relatively favorable path in the final quarter. Production of capital goods went slightly up during October-November compared to the previous quarter. Production of capital goods excluding vehicles, an indicator for the underlying trend, posted a larger increase than total capital goods. Similarly, there were increases in imports of capital goods as well. The expectation for fixed capital investment spending asked in the Business Tendency Survey continued to rise for the fourth consecutive month and surpassed the third-quarter level in the fourth quarter.
10. Survey indicators for the final quarter suggest that economic activity continues to recover. In fact, both the Business Tendency Survey's past-three-month production question and the PMI index exceeded their third-quarter averages. The BTS' three-month-ahead order expectations increased significantly for both domestic and export markets.

11. Recent indicators suggest that exports continue to grow modestly. In fact, the non-gold export volume index was up in October-November from the third-quarter average. PMI indicators point to a global recovery, while world import demand is surging. The recovery of the euro area, Turkey's leading trading partner accounting for a substantial portion of Turkish exports, and the improving global growth outlook indicate that net exports may make a positive contribution to growth in the upcoming period.
12. The Committee stated that the recent hike in risk premiums and exchange rates might put pressure on private demand in the first quarter of 2014. In fact, the preliminary CNBC-e consumer confidence index for the first fifteen days of January shows deterioration in consumer sentiment about current economic conditions and future expectations. However, it is noted that the expected recovery of external demand will restrict the slowdown in total demand. Accordingly, the composition of growth is expected to support the decline in both inflation and current account balance in the upcoming period.
13. Seasonally adjusted unemployment rates fell in October 2013 thanks to growing non-farm employment. Although the uptrend in unemployment halted, the rise in non-farm employment is restricted to certain sectors. Employment remains weak in the industrial sector, while the increase in non-farm employment came mostly from construction and services sectors. Leading indicators for labor markets show signs of a moderately growing employment for November and December. Yet, global economic uncertainties and domestic political developments may remain a constraint to investment and employment growth for the upcoming period

Monetary Policy and Risks

14. The meeting involved an assessment of the January Inflation Report forecasts. According to the Committee, recent data suggest that final domestic demand and exports continued to grow at a moderate pace during the fourth quarter. It was stated that the cautious monetary policy stance, the announced macroprudential measures, and weak capital flows lead to a gradual slowdown in loan growth. Combined with the impact of recent domestic uncertainties, private demand is expected to slow down in the first quarter. Meanwhile, the expected recovery in the economic activity in Europe should have a positive impact on the external demand. Accordingly, the decline in the current account deficit excluding gold trade is expected to be more significant in 2014.

15. The Committee closely monitors the impact of the recent increase in the risk premium on the inflation outlook and expectations. Inflation is likely to hover above the 5 percent target for some time due to recent tax adjustments and lagged effects of exchange rate developments. Moreover, the volatility in unprocessed food prices adds to the uncertainty regarding inflation forecasts.
16. The Committee stated that the liquidity stance should be tightened to align inflation outlook with the medium term targets. It was indicated that, given the recently heightened uncertainties, designing a flexible mechanism would be more appropriate. To this end, it was stated that interbank money market interest rates will materialize at 9 percent during additional monetary tightening days, instead of 7.75 percent. In this respect, Central Bank lending rate (the marginal funding rate) will be announced and implemented at 9 percent, instead of 7.75 percent during the additional tightening days.
17. Moreover, the Committee indicated that the upper limit of the amount of funding provided at stable funding rate-1 may be removed due to the increased funding need of the financial system in the recent period.
18. The Committee closely monitors inflation expectations and the pricing behavior. The slowdown in domestic demand is expected to contain the effect of the cost-push shocks on inflation to some extent in the coming period. However, lagged effects of the exchange rate movements and the unfavorable course of food prices are likely to cause inflation to remain above the target for an extended period, which may result in higher rigidity in expectations and stronger inflation inertia. Materialization of such a scenario and deterioration of pricing behavior may prompt the Committee to implement the necessary tightening in the monetary policy stance.
19. On the other hand, should these uncertainties and the increase in the risk premium last for a long time, the economy may face a pronounced slowdown through the confidence and balance-sheet channels. Should such a risk materialize, the Central Bank will pursue a stabilizing policy by using its policy instruments to reduce the intermediation costs of the banks.
20. The Committee closely monitors developments on fiscal policy and tax adjustments with regard to their effects on the inflation outlook. Inflation forecasts presented in the baseline scenario take the framework outlined in the Medium Term Program as given. Accordingly, it is assumed that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly

from this framework, and consequently, has an adverse effect on the medium-term inflation outlook.

21. 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.