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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 24 April 2014

Inflation Developments

1. In March, consumer prices rose by 1.13 percent month-on-month, and annual inflation increased by 0.5 points to 8.39 percent. The lagged effects of the depreciation in the Turkish lira continued to affect core inflation indicators adversely, particularly through the core goods channel. This, along with the unfavorable course of food prices, will cause inflation indicators to remain high for some time.

2. Annual food group inflation increased slightly to 10.12 percent. In the first quarter, fruit and vegetable prices were moderate, while food prices excluding this group were substantially unfavorable. Especially processed food prices posted a sharp rise in the first three months of the year due to the depreciation of the Turkish lira and adverse weather conditions. Owing to these effects, the annual food price inflation is expected to rise further in April.

3. Prices of services edged up by 0.65 percent month-on-month, and the group's annual inflation increased by 0.26 points to 8.60 percent. This was largely attributed to the dramatic increase in catering prices (restaurants-hotels) caused by the developments in food prices excluding fruit and vegetables. Additionally, annual inflation in other services items excluding rents and transportation also increased. The seasonally adjusted data point to an ongoing rise in the underlying trend of services inflation in this period as well.

4. Annual core goods inflation increased by a marked 1.64 points to 10.04 percent in March. The annual inflation in durable consumer goods rising on the back of the Turkish lira depreciation reached 15 percent. Meanwhile, clothing prices recorded the highest March increase in the history of the index. This was mainly driven by cost and external demand related developments as well as the early launch of the new season. March was marked by a strong exchange rate pass-through across the core goods group. Accordingly, the seasonally-adjusted data pointed to a notable rise in the underlying trend of the core goods inflation. Thus, core inflation indicators registered a negative outlook as well.

Factors Affecting Inflation

5. According to the Gross Domestic Product (GDP) data for the fourth quarter of 2013, economic activity was largely consistent with the outlook presented in the January Inflation Report. In seasonally adjusted terms, GDP grew by 0.5 percent quarter-on-quarter, allowing economic activity to be more moderate in the second half of the year after a robust acceleration in the first half. Final domestic demand increased at a more rapid pace after a weak second and third quarter. Among final domestic demand components, private demand remained modest throughout 2013, while public demand followed a volatile path, thus determining the direction of domestic demand. In the fourth quarter, exports increased at a faster pace than imports on a quarterly basis, and demand components moved in the direction of rebalancing compared to the first half of the year as expected.

6. Data for the first quarter of 2014 suggest that economic activity grew moderately. On the production side, the industrial production index remained broadly unchanged month-on-month in February after registering a monthly 1.0 percent increase in January. Thus, production was 1.7 percent higher from the previous quarter's average during January-February and continued to grow steadily in quarterly terms. In the upcoming period, production is expected to grow further on the back of exports and the modest domestic demand.

7. Data on spending show that private demand weakened in the first quarter due to developments in the consumption of durable goods and the private machinery-equipment. On the other hand, data on the consumption of nondurable goods and construction investments remain favorable. Among subcategories of imports of consumption goods, during January-February, imports of automobiles plunged, while imports of durable and semi-durable goods fell modestly and imports of nondurable goods continued to rise. In this period, the production of durable goods was down from the previous quarter, whereas the production of nondurable goods remained on the rise. As an indicator for machinery-equipment investments, the production of investment goods excluding transport somewhat flattened while imports of the same group declined. Moreover, data regarding construction investments show that the increase in construction investments continued.

8. With the reduced uncertainty, the small yet discernible recovery in confidence indices and the appreciation of the Turkish lira, a recovery is expected in consumption demand. With the support of this recovery, domestic demand is expected to start growing steadily by the second quarter. Yet, second-quarter

loan and imports data and BTS indices suggest that this recovery will be a moderate one.

9. Recent data show that exports continued to grow in the first quarter of 2014. The non-gold export volume index was up month-on-month in January and February and hovered above its fourth-quarter average during January-February. With the support of the global recovery signaled by recent survey indicators, the pickup in international trade and the Turkish lira depreciation, exports are expected to make a positive contribution to growth in the upcoming period. PMI and BTS export indicators hint at a similar pattern.

10. In sum, recent data releases indicate that final domestic demand will lose momentum in the first quarter, whereas exports will limit the impact of this slowdown on growth. With recent decline in uncertainties, private demand may start recovering as well by the second quarter of the year, which, however, might be curbed by tight financial conditions. Against this background, the Committee expects the rebalancing to continue and the current account deficit to improve significantly in 2014.

11. In seasonally adjusted terms, total and non-farm unemployment rates continued to fall in January 2014. 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. After having plummeted during the first months of 2014, confidence indices increased month-on-month in March. Furthermore, total employment expectations, a BTS indicator, continued to deliver positive returns despite a seasonally-adjusted monthly decline in April.

Monetary Policy and Risks

12. The Committee assessed the medium-term forecasts to be published in the April Inflation Report. It was noted that the main reason behind the annual consumer inflation’s overshooting of January forecasts in the first quarter of 2014 was exchange rate movements and the unfavorable course of food prices. Upon evaluating both the assumptions underlying inflation forecasts and external conditions, the end-2014 inflation forecast is revised upwards in view of exchange rates, import and oil prices, food prices and developments in underlying inflation trend.

13. The Committee stated that loan growth rates continue to slow down in response to the tight monetary stance and the recent macro prudential measures. The

slowdown in loan growth is mostly attributed to consumer loans and credit cards, while commercial loans expand at a rate similar to past years. This positive development in loan growth composition is expected to contribute to financial stability, the rebalancing process and the decrease in inflation. As a matter of fact, data regarding the first quarter of 2014 indicate some deceleration in private final domestic demand. Meanwhile, net exports are expected to contribute positively to economic growth thanks to the recovery in external demand, particularly from European countries, and real exchange rate developments. Given such a demand composition, the Committee expects that aggregate demand conditions will contain inflationary pressures and the current account deficit will exhibit a significant improvement in 2014.

14. The Committee closely monitors inflation expectations and the pricing behavior. The slowdown in consumer loans and the weak private demand are expected to restrict the effect of the cost-push shocks on inflation 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 some time. Given the elevated level of inflation, the Committee stated that it is important to prevent the negative effects on the pricing behavior and on the inflation trend. The strong and front-loaded 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, considering that the positive impact of the monetary tightening will be observed on inflation with some lag, inflation might continue to increase in the short term, partly reflecting the base effects. In the meantime, the Committee will closely monitor inflation expectations and the pricing behavior and maintain the tight monetary policy stance until there is a significant improvement in the inflation outlook.

15. In times when negative effects on the inflation outlook are strong and uncertainties are large, the Central Bank may tighten the liquidity policy further to restrict these developments. During additional tightening, the yield curve can be inverted if necessary. The Committee indicated that the recent decline in uncertainties and the partial improvement in risk premium indicators have reduced the need for an additional tightening in liquidity policy. With the deceleration in private demand and the significant slowdown in consumer loans, the current tight monetary stance is believed to be enough to attain an inflation outlook consistent with medium term targets. In case of further deterioration in the trend of inflation or a dramatic rise in uncertainties, the Central Bank might implement additional tightening in liquidity policy.

16. As the uncertainty about the Fed's quantitative easing program has recently faded to a great extent and thanks to the global economic recovery, the risk

sentiment across global financial markets has become more upbeat. Yet, expectations about the timing and pace of a Fed rate hike are of importance for pricing in financial markets. However, because the transmission mechanism of the interest rate channel is better known than quantitative easing and the monetary policy dependence on high-frequency data has decreased in this process, the uncertainty effect of an interest rate hike on financial markets might be more limited than that of the exit from the quantitative easing program. Hence, capital may start flowing back to emerging economies. Moreover, the ECB's possible quantitative easing might be another supporting factor for capital flows. If this scenario materializes, the Central Bank might take steps to accumulate foreign exchange reserves.

17. On the other hand, should there be long-lasting increases in uncertainties and risk premium; the economy may face an additional slowdown through the confidence and balance sheet channels. If such a risk materializes, the Central Bank will pursue a stabilizing policy by using its policy instruments to reduce the intermediation costs of the banks. In a scenario where it is necessary to tighten the liquidity policy, macro prudential tools might be used as a stabilizer to contain the repercussions on banking costs. Similarly, in a scenario where the external funding conditions tighten for banking sector, macro prudential policies might be implemented in a stabilizing way. The Committee pointed out the possibility of paying interest to the portion of reserve requirements held in Turkish liras in this context.

18. The Committee closely monitors developments on fiscal policy and tax adjustments with regard to their effects on the inflation outlook. The baseline monetary stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes on 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, have an adverse effect on the medium-term inflation outlook.

19. 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 improving social welfare by keeping interest rates of long-term government securities at low levels. In this respect, implementing the structural reforms required by the MTP remains to be of utmost importance.