TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 22 December2015

Inflation Developments

1. In November, consumer prices increased by 0.67 percent, and annual inflation edged up by 0.52 points to 8.10 percent. Annual food inflation increased on account of the unprocessed food prices, while the annual energy inflation rose due to the base effect. Meanwhile, the effects of depreciation in the Turkish lira, albeit waning, pushed annual inflation in core goods further upwards. Annual services inflation maintained its high levels. Thus, annual inflation of core indicators recorded an increase, while the underlying trend of inflation implied by seasonally adjusted data remained flat.

2. Annual inflation in food and non-alcoholic beverages rose by 0.83 points to 9.51 percent in November. This was driven by annual unprocessed food inflation that climbed to 11.48 percent mostly due to rising prices of vegetables. On the processed food front, the downward trend in annual inflation continued. Energy prices edged down by 0.31 percent in tandem with the decline in fuel prices, while the annual energy inflation increased to 1.26 percent due to base effect in November. The annual energy inflation is projected to increase further in December on account of the base effect.

3. Prices of services increased by 0.17 percent, and annual services inflation rose by 0.16 points to 8.80 percent in November. Annual inflation slowed in the restaurants-hotels group, but edged up in other sub-groups. The seasonally-adjusted data indicated a slight slowdown in the underlying trend of services inflation in November.

4. Annual core goods inflation rose by 0.41 points to 9.61 percent in November. The cumulative depreciation in the Turkish lira continued to affect core inflation despite alleviating in certain items. Monthly price increases in durable goods decelerated in November following higher levels in the preceding two months. However, clothing prices remained on an increasing path. As a consequence, seasonally-adjusted data indicated an increase in the underlying trend of core goods inflation. Meanwhile,

the annual inflation in core goods excluding clothing and durables reached 8.67 percent in November.

5. In sum, lagged effects of the exchange rate movements continued to delay the improvement in inflation, but the decline in oil prices contained this effect. Against this backdrop, core inflation remained on an upward trend in November.

Factors Affecting Inflation

6. According to data released by TURKSTAT, the Gross Domestic Product (GDP) grew by 4.0 percent year-on-year in the third quarter of 2015. In seasonally-adjusted terms, national income maintained its robust growth, posting an increase by 1.3 percent quarter-on-quarter. On the expenditure side, net exports made a considerably high contribution to quarterly growth amid the rise in exports and decline in imports. Consumption spending continued to expand, while investment spending remained relatively weak in this quarter.

7. Owing to the base effect from number of working days, industrial production registered a notable year-on-year growth in October. In seasonally and calendar-adjusted terms, October production figure was flat compared to the previous month, but 1.0 percent higher than the third-quarter average. Among indicators of November, the manufacture of vehicles and electricity generation receded. The Business Tendency Survey data and the PMI indicators for the last three months point to an increase in production due to waning domestic uncertainties. Accordingly, industrial production is projected to rise on a quarterly basis in the last quarter of the year.

8. Data on the expenditure side suggest a more moderate demand growth in the last quarter. Following a slight decline in the third quarter, sales of automobiles remained below the previous quarter's average in the October-November period. Sales of white goods also recorded a decline in the October-November period. Imports of investment goods receded on a monthly basis. Indicators of construction investment exhibit a mild pattern, while future investment expectations of firms point to a recovery in the October-November period. In sum, domestic demand is likely to provide a modest contribution to growth in the last quarter.

9. Recent rebound in confidence indicators ease the downside risks to economic activity. Business survey data indicate that export orders over the last three months recorded an improvement in the October-November period, while domestic orders, which remained moderate in the first three quarters, assumed a recovery trend recently. Moreover, the consumer confidence has increased notably. Likewise, investment and employment prospects improved in the October-November period. Against this background, confidence channel is expected to boost domestic demand in the upcoming period.

10. Current account balance continues to improve. Although geopolitical tensions still weigh on export growth, the robust increasing trend in exports to Europe provides support to growth and rebalancing. Current account balance is expected to further improve in the upcoming period, owing to the lagged effects of the fall in oil prices and the slowdown in credit growth.

11. In September 2015, non-farm unemployment rate recorded a limited decline upon the increase in employment. Labor force in non-farm sectors trended upwards in this period. Among sectors, industrial employment claimed the highest rate of increase in September following a decline of three quarters in a row. Employment in the construction sector edged up, while that in the services sector followed a robust course. Going ahead, industrial production and survey indicators signal a mild increase in employment. Given the economic outlook, the current trends in services and construction employment is expected to be maintained. Overall, non-farm unemployment may recede in the last quarter of the year.

12. To sum up, recent indicators suggest that domestic demand follows a more moderate course in the last quarter of the year, while external demand offers positive contribution to growth. Although geopolitical tensions pose a downside risk to external demand, the recovery in the European economies contributes to external demand. Meanwhile, the recovery in consumer confidence as well as investment and employment prospects amid waning domestic uncertainties is likely to support domestic demand in the upcoming period. Hence, economic activity is expected to maintain a stable growth trend.

Monetary Policy and Risks

13. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. Although loan growth has recently displayed a downward trend, the recovery in financial conditions and higher revenues due to wage hikes are expected to support loan growth in the upcoming period. Commercial loans continue to grow at a faster pace than consumer loans. Such a composition not only limits medium-term inflationary pressures but also supports the improvement in the current account balance.

14. In the third quarter of the year, growth composition turned in favor of net exports on a quarterly basis. Following a robust trend in the first half, domestic demand displayed a milder course in the second half of the year, as projected. Although the geopolitical tension resides as a downward risk to external demand, this risk is contained by the flexibility of our exports in shifting markets. In fact, Turkish exports towards the European Union countries recently gained considerable momentum. Moreover, favorable developments in the terms of trade and the deceleration in consumer loans contribute to the improvement in the current account balance.

Therefore, the annual current account deficit is expected to narrow further in the upcoming period.

15. The Committee stated that the desired improvement in the inflation outlook is yet to be seen. Although energy price developments continue to affect inflation favorably, cumulative exchange rate movements delay the improvement in the core inflation trend. Exchange rates followed a relatively stable course during the final quarter of the year amid easing domestic uncertainties and the significant improvement in the current account balance. However, the lagged pass-through from the cumulative depreciation in the first three quarters continued to have an adverse impact on inflation. Accordingly, core inflation indicators are expected to remain at high levels in the short run. In addition, year-end unprocessed food inflation is likely to exceed the October Inflation Report projections. The effect of higher-than-targeted inflation on expectations and the acceleration in wage increases necessitate close monitoring of the overall pricing behavior. Against this backdrop, the Committee stated that the tight liquidity stance would be maintained as long as deemed necessary.

16. Future monetary policy decisions will be conditional on the factors affecting the inflation outlook. Taking into account inflation expectations, the pricing behavior and developments in other factors affecting inflation, the tight monetary policy stance will be maintained.

17. The Committee stated that the wide interest rate corridor has contributed to containing exchange rate volatility in times of heightened global volatility. The need for such an instrument would be reduced, should the decline in volatility observed after the start of the global policy normalization prove persistent.

18. Another factor reducing the need for a wide interest rate corridor is the effective use of policy instruments laid out in the roadmap published in August. Excessive fluctuations both in exchange rates and loans have waned owing to the launch and effective use of these instruments.

19. In this respect, the Committee highlighted the significance of the measures to stabilize the foreign exchange liquidity during the simplification process. To this end, it was indicated that the automatic stabilizer feature of the ROM will be strengthened before the monetary policy simplification, as elaborated in the Monetary and Exchange Rate Policy for 2016. Moreover, it was reiterated that conditions and limits regarding the pledge of foreign currency deposits as collateral against Turkish lira operations might be revised before and during simplification.

20. Against this background, monetary policy simplification steps would begin with the next meeting, should the decline in volatility prove persistent. The interest rate corridor is aimed to be narrower and more symmetrical around the one-week repo rate. The nature and the pace of simplification steps will depend on the factors affecting the volatility in global and domestic markets.

21. Developments in the fiscal policy and tax adjustments are monitored 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 maintained and there will be no unanticipated hikes in administered prices. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

22. Sustained fiscal discipline has become a fundamental element in reducing the sensitivity of the Turkish economy against external shocks in recent years. Given the current environment of highly uncertain global markets, maintaining and further advancing these achievements is significant. Any measure to ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping interest rates of long-term government securities at low levels.