TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 22 April 2015

Inflation Developments

1. In March, consumer prices increased by 1.19 percent and annual inflation rose by 0.06 points to 7.61 percent. Inflation in food and related services maintained its high course, while the decline in the annual consumer inflation excluding food and catering services continued. Underlying trends of core inflation indicators registered some increase in this period.
2. Annual inflation in food and non-alcoholic beverages rose by 0.42 points to 14.12 percent. This was led by unprocessed food prices, and ongoing price hikes particularly in vegetables-fruits and meat stood out. On the other hand, annual inflation receded in processed food prices. Unfavorable influence of food prices to inflation continued with an increasing trend in this period and contribution of food group reached 3.47 points in annual inflation. On the other hand, energy prices rose by 1.60 percent in March, yet the group's annual inflation remained low with 0.19 percent.
3. Prices of services were up by 0.56 percent in March, while annual services inflation fell by 0.1 points to 8.53 percent. Annual inflation slowed in groups other than rents and restaurants-hotels. Due to the increased cost pressures driven by food prices, the divergence between the annual inflation rates of catering prices and other services groups continued. The rise in the underlying trend of services inflation in February continued in this period.
4. Annual inflation of core goods decreased by 1.25 points to 5.54 percent in March. Annual inflation was down across all main categories, particularly in durable goods, largely due to the base effect. In the first quarter, pass-through of the exchange rate developments to core goods inflation under attenuated demand conditions proved limited. Meanwhile, the underlying trend of core goods inflation exhibited some deterioration.

5. To sum up, the ongoing cautious monetary policy along with prudent fiscal and macroprudential policies continue to have a favorable impact on inflation, especially inflation excluding energy and food (core inflation indicators). Despite the slowdown in domestic demand, the high course of food prices and the exchange rate developments are the key risk factors regarding the inflation outlook in the upcoming period.

Factors Affecting Inflation

6. According to data released by TURKSTAT, Gross Domestic Product (GDP) grew by 2.6 percent year-on-year in the fourth quarter of 2014. Thus, annual growth ended 2014 at 2.9 percent. On the production side, the value-added from all sectors except construction posted year-on-year increases in the final quarter. Yet, over 2014, the agricultural value-added contributed negatively to annual growth due to drought-driven production losses, whereas value-added of construction, industry and services sectors expanded. On the spending front, the private demand for consumption and machinery-equipment investment added to growth in the fourth quarter, while the public sector made a weaker contribution. Net exports made a negative contribution to growth in this period as imports increased at a faster pace than exports. Over 2014, Europe's sluggish growth and geopolitical tensions across neighboring countries dampened exports. However, imports nearly flattened on the back of the slowing rate of increase in domestic demand, making net exports the demand component that provided the highest contribution to growth in 2014.

7. Data released for the first quarter of 2015 point to a relatively weak outlook for economic activity. Although industrial production recorded a monthly increase of 1.7 percent in February, the level of production remained unchanged from the fourth quarter of 2014 during January-February period. This outlook is mostly attributed to the slowdown in domestic demand growth and the weak external demand as well as to the setbacks in the supply chain and construction activities caused by adverse weather conditions in January and February. PMI and Business Tendency Survey (BTS) data suggest that this weak course will continue in March.

8. Data on the expenditure side show that the production of consumer goods was lower than the previous quarter's average, while the imports of consumer goods were on the rise. In this period, domestic sales of home appliances dropped. Yet, sales of automobiles were up in the first quarter. Consumer confidence continued to weaken amid uncertainty over global markets. Among indicators for investments, the production and imports of machinery-equipment went down from the previous quarter's average. Among variables related to construction investments, the production and imports of minerals declined. The investment tendency failed to demonstrate a steady recovery in the first quarter of 2015, thus remaining weak. Against this background, private domestic demand is expected to slow down slightly and contribute moderately to growth in the first quarter of 2015.

9. External demand indicators show that the rebalancing process based on goods excluding gold, which came to a halt in the second half of 2014, has not shown an improvement as of January-February. This outlook is largely driven by the weak growth across Turkey's trading partners and the slowing yet ongoing domestic demand growth. In fact, during this period non-gold exports were down, while non-gold imports increased from their averages in the previous quarter. Nevertheless, the favorable developments in the terms of trade and the moderate course of consumer loans continue to contribute to the improvement in the current account balance.

10. In January 2015, both total and nonfarm unemployment rates decreased on the back of rising nonfarm employment. Across nonfarm sectors, services employment continued to grow whereas construction employment maintained the negative pattern that started in December. On the other hand, after falling in previous months, industrial employment regained momentum, providing a major contribution to the fall in unemployment.

11. To summarize, first-quarter data have yet to signal a recovery in economic activity. In this period, external demand weakened, but domestic demand is expected to contribute moderately to growth. However, the uncertainty over global markets and the weak course of consumer and investor confidence increase the downside risks to growth for the upcoming period. Thus, demand conditions are expected to support disinflation.

Monetary Policy and Risks

12. Loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. The composition of loans also continues to evolve in the desired direction. Commercial loans grow at a faster pace than consumer loans. This loan outlook not only limits medium-term inflationary pressures but also contributes to the improvement in the current account balance.

13. The weak external demand caused by the sluggish growth across European countries, the largest export market for Turkey, and geopolitical developments in neighboring countries continues to limit the growth of exports. In addition to the weak external demand, the recent plunge in the value of the euro against the US dollar may have an adverse impact on firms that export in euro, but Turkey's share in the European market remains robust. The recent signs of recovery for the European economy might be a development that would boost the external demand.

14. The Monetary Policy Committee (the Committee) stated that economic activity lost some momentum in the first quarter. This slowdown was largely due to the weak external demand, volatility in financial markets and adverse weather conditions. Although economic activity is expected to grow gradually and moderately from the second quarter onwards, downside risks remain important. Lingering volatility in global financial markets and the weak course of confidence indices are the risk factors that may limit the contribution of the private sector final demand to growth.

In case of an additional slowdown in external demand and a sizeable decline in global growth rates, the decrease in commodity prices will pull inflation down but at the same time lead to notable adverse effects on domestic economic activity. Under such circumstances, the Committee will employ the policy tools to support the economy.

15. The Committee evaluated the medium-term forecasts to be published in the April Inflation Report. The first quarter's higher-than-projected annual consumer inflation compared to the January Inflation Report is mostly attributed to soaring food prices. Moreover, oil prices and TL-denominated import prices put cost pressures on inflation. Analyzing the assumptions and external conditions that underlie the inflation forecasts, the end-2015 inflation forecast is revised upwards in view of oil prices, TL-denominated import prices and output gap developments.

16. The ongoing cautious monetary policy along with prudent fiscal and macroprudential policies are having a favorable impact on inflation, especially inflation excluding energy and food (core inflation indicators). Low levels of international commodity prices and the moderate course of aggregate demand conditions support disinflation. The Committee expects the annual inflation of core indicators to decline further in the short run, with also contribution of base effects. However, the recent exchange rate movements may have an adverse impact on the core inflation outlook.

17. Food prices remain as the main risk factor for the inflation forecast. Although food inflation is expected to remain high in the short term according to the baseline scenario, food prices are likely to see a notable correction upon the introduction of new-season products in the summer months. Moreover, measures that may be proposed by the Food Committee are assessed to contribute to the decline in the food inflation in the upcoming period. However, prices of some food items are sensitive to the exchange rate and there are uncertainties over supply-side developments, which necessitate caution against food inflation.

18. Global markets continue to follow a volatile course. Reduced predictability of global economy and increased uncertainties amid the divergence among the monetary policies of advanced economies cause global markets to remain highly data-sensitive. Against this background, the volatility in the risk appetite and capital flows continues. The Committee emphasized that measures recently taken in the FX liquidity, intermediation costs and prudential borrowing aimed at reducing macrofinancial risks stemming from uncertainties regarding global financial markets and the course of economic activity. Macro financial risks will be closely monitored in the upcoming period and additional measures will be taken when deemed necessary.

19. In sum, the uncertainty in global markets and elevated food prices necessitate maintaining the cautious stance in monetary policy. Future monetary policy decisions will be conditional on the pace of improvements in the inflation outlook. Inflation expectations, pricing behavior and other factors that affect inflation will be monitored closely and the cautious monetary policy stance will be maintained, by

keeping a flat yield curve, until there is a significant improvement in the inflation outlook.

20. Developments on 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 on 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.

21. The Committee assessed that the implementation of the announced structural reforms would contribute significantly to potential growth. Any measure that would 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.