

PRESS RELEASE

1 October 2015

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 22 September 2015

Inflation Developments

1. In August, consumer prices increased by 0.40 percent, and annual inflation edged up by 0.33 points to 7.14 percent. In this period, consumer prices were affected by the lagged impact of the depreciation in the Turkish lira. Annual food inflation increased, whereas falling oil prices continued to pull energy inflation down. Annual inflation in core goods and services edged up, leading to an increase in core inflation indicators. Seasonally adjusted data indicate that the underlying recent trend of inflation slowed down, yet remained at high levels.
2. Following the flat course in July, annual inflation in food and non-alcoholic beverages rose by 0.46 points to 9.71 percent in August. Soaring fruit prices was the main driver of the increase in food inflation. Moreover, meat prices continued to increase, contributing to the upside movement in the unprocessed food inflation. On the processed food front, the downward trend in annual inflation continued, but monthly price increase remained still high at 0.83 percent. Leading indicators on September inflation point that annual unprocessed food inflation may post another increase with rising fresh fruits and vegetables prices. Meanwhile, energy prices went down by 0.76 percent in August and continued to affect inflation favorably. With the ongoing decline in crude oil prices, annual energy inflation receded to 1.26 percent.
3. Prices of services rose by 1.14 percent in August, and annual services inflation crept up by 0.24 points to 8.65 percent. In this period annual inflation increased across all main subcategories except transport, reflecting the effects of the depreciation in the Turkish lira. Ongoing cost pressures driven by food inflation pushed prices in the restaurants-hotels group up by 2.05 percent, leading this group to hit the highest monthly inflation of the last nine years. On the other hand, amid the low course of crude oil prices, annual inflation in transport services remained at modest levels. Overall, underlying trend of services inflation edged up in August.

4. Annual core goods inflation rose by 0.52 points to 6.58 percent in August. Cumulative depreciation in the Turkish lira has adversely affected prices in the core goods group, especially the durable goods. Durable goods annual inflation increased to 7.04 percent, led by the rising of prices electrical and non-electrical appliances. Indicators on September point that exchange rate pass-through will continue to affect the prices of durable consumption goods.
5. In sum, the Monetary Policy Committee (the Committee) assessed that developments in energy prices continue to affect inflation favorably, yet exchange rate movements delay the improvement in the core inflation trend.

Factors Affecting Inflation

6. According to TurkStat, GDP grew by an annual 3.8 percent in the second quarter of 2015. Final domestic demand increased on the back of both private and public sectors, with private demand registering a stronger growth. Private consumption and private investments, respectively, contributed the most to the second quarter's annual growth. The imports expanded with the continued rise in domestic demand while the weak foreign demand brought exports down, causing net exports to contribute negatively to annual growth.
7. In July, industrial production decreased by 1.5 percent month-on-month in seasonally adjusted terms, falling below the second-quarter average by 0.9 percent. This production drop is largely attributed to the correction of June's sharp increase and the reduced number of working days due to factors such as bridge days. Leading indicators for August signal a mild rise in production.
8. Data on the expenditure side indicate that domestic demand may be more moderate in the second half than in the first half. In July, the production of consumption goods posted a monthly decline whereas the imports of consumption goods grew on the back of automobiles demand. The strong uptrend in the sales of automobiles slowed somewhat during July-August period. Sales of home appliances were slightly down during July-August compared to the second quarter. Consumer confidence indices continue to weaken as of August. Indicators for the construction industry do not reveal a robust recovery in construction activity, while firms' expectations for future investments hint at no significant improvement.
9. Due to the first half's weaker exports and rising consumption demand, the current account balance ceased to improve. Data for August and September point to a slowing import demand while export orders seem to have recovered slightly. The growth composition is expected to shift gradually towards net exports over the upcoming period thanks to a rising demand from EU members. Amid this

composition change and lower oil prices, the improvement in the current account balance is expected to be more significant in the forthcoming period.

10. In June, nonfarm employment remained flat while labor force participation continued to rise. Thus, unemployment rates registered an increase. Services employment remained on the rise whereas industrial and construction employment decreased marginally. Industrial production and survey indicators suggest that industrial employment may fail to contribute to nonfarm employment growth in the third quarter after the modest first-half increase. Taken with the other leading indicators, no major gains are expected for employment in the upcoming period. The economic outlook and the weak investment tendency pose a downside risk to employment.
11. To sum up, current indicators suggest that domestic demand growth is likely to be more moderate in the forthcoming period than in the first half of the year. Uncertainties in global markets and the weak course of confidence indices add to the downside risks to the growth outlook and employment. Thus, demand conditions are likely to support disinflation.

Monetary Policy and Risks

12. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. The Committee highlighted that loan growth has displayed a notable deceleration due to tighter financial conditions recently. Specifically, FX commercial loans and consumer loans have lost significant momentum in recent weeks, which, as evaluated by the Committee, is mostly demand-driven.
13. External demand remained weak in the first half of the year, while domestic demand contributed to growth moderately. The weak consumer confidence and the recent sales data point to a slowdown in consumption demand for the second half of the year. The recent increase in relative prices of investment and durable goods will curb the demand in these sectors. Accordingly, imports are expected to slow in the upcoming period. On the exports front, despite the negative impact of geopolitical developments, the rising demand from EU members is likely to affect Turkey's exports positively. Against this background, the Committee expects the growth composition to shift gradually towards net exports in the upcoming period, which will have a favorable impact on the current account balance. Moreover, the developments in the terms of trade and the moderate course of consumer loans contribute to the improvement in the current account balance. Accordingly, the current account balance is expected to display a significant improvement starting with the August figures.

14. Energy price developments continue to affect inflation favorably. The upward impact of the exchange rate developments on inflation is partly offset by lower oil prices. Yet, the accumulated pass-through from exchange rate developments delay the recovery in the core inflation trend. Leading indicators signal that the exchange rate pass-through to domestic prices continue to exert upside pressures on inflation. Considering these developments and the recent increase in inflation expectations, the Committee stated that the overall pricing behavior should be monitored closely.
15. Food prices remain volatile. Even though unprocessed food prices are expected to post a downward correction in the final quarter, the course of food prices as of September poses an upside risk to the year-end food inflation forecast. In addition, the ongoing volatility across global markets necessitates a cautious monetary stance. Overall, considering the impact of the uncertainty in domestic and global markets on inflation expectations and taking into account the volatility in energy and food prices, the Committee decided to maintain the tight liquidity stance as long as deemed necessary.
16. Future monetary policy decisions will be conditional on the improvements in the inflation outlook. Inflation expectations, the 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.
17. The Committee also assessed the measures already implemented and to be implemented in the context of the “road map during the normalization of global monetary policies”. The measures announced within the road map has largely been put into effect over the last one month. Accordingly, further measures were taken to support the FX liquidity, core liabilities and long-term borrowing. Moreover, the operational framework of the liquidity policy was simplified. In this respect, the overnight borrowing facility provided for primary dealers via repo transactions was terminated and collateral conditions were simplified. According to the Committee, the arrangements regarding the use of FX deposits as collateral for TL operations will increase the efficiency of the banks’ liquidity management practices. It was underlined that all these steps will continue to boost the resilience of the economy against global shocks. The Committee reiterated that the Central Bank’s current monetary policy stance can be summarized as tight against the inflation outlook, stabilizing for FX liquidity, and supportive for financial stability.
18. 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.

19. Sustained fiscal discipline has become a fundamental element in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current environment of highly uncertain global markets, the value added from maintaining and further advancing these achievements is significant. 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.