

PRESS RELEASE

3 March 2015

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 24 February 2015

Inflation Developments

1. In January, consumer prices increased by 1.10 percent and annual inflation fell by 0.93 point to 7.24 percent. This fall was mainly driven by energy and food prices, and inflation lost pace in almost all sub-groups except services. The decline in energy prices continued in line with falling international oil prices. The improvement in the underlying trend of core indicators was sustained due to core goods.
2. Annual food inflation decreased by 1.76 points to 10.97 percent. Although the seasonally-adjusted unprocessed food prices increased in January following the decline in the last four months, the group's inflation fell to 9.39 percent. Processed food prices recorded a monthly upsurge, yet the group's annual inflation receded to 12.56 percent also due to the high base. Being also affected by adverse weather conditions, the indicators for February signal a possible uptick in the annual food inflation due to the unprocessed food group.
3. Energy prices remained on the decline and fell by 0.78 percent in January. The group's annual inflation dropped by 1.50 points to -3.04 percent, hitting the lowest level of the index history. The effects of the decline in oil prices on energy prices appeared in fuel and bottled gas prices, while the upsurge in municipal water tariffs was remarkable. Meanwhile, the increase in fuel prices after six months in February due to the depreciation in the Turkish lira and the rise in oil prices indicates that the contribution of energy group to the decline in annual consumer inflation will be restricted to some extent.
4. Annual core goods inflation edged down approximately by 0.3 points to 8.57 percent. This was led by prices of goods excluding clothing, particularly durable consumption goods. Although the group's annual inflation decreased mostly owing to the base effect, prices surged across durables. In groups excluding durables and clothing, annual inflation decreased while there were increases in the monthly inflation. Recent exchange rate developments may restrict the fall in core goods inflation, yet a notable decline in core goods is expected in the first quarter.

5. Prices of services increased by 1.06 percent and the group's annual inflation crept up by 0.14 points to 8.73 percent mainly due to communication and other services groups. Moreover, maintenance-repair and healthcare services also saw an increase in inflation in this period. Additionally, the annual inflation in the restaurants-hotels group maintained its high course owing to the negative developments in food prices. Accordingly, the seasonally-adjusted data exhibit an increase in the underlying trend of services inflation.
6. In sum, January was marked by a sustained improvement in the underlying trend of core inflation indicators and favorable figures in energy inflation amid the lingering fall in international oil prices. Core inflation is projected to decline further in the upcoming period in line with the maintained reasonable levels in inflation trends.

Factors Affecting Inflation

7. Data announced for the final quarter of 2014 point to a limited recovery for economic activity. Industrial production increased 1.2 percent in December, but fell by 0.5 percent quarter-on-quarter due to the volatility in other transport vehicles and the Feast of the Sacrifice. The dampening effects of the weak external demand have become more evident, while domestic demand has yet to accelerate adequately, which keeps economic activity from a robust recovery.
8. According to data on the expenditure side, in the final quarter of 2014, the production of consumer goods was higher than the previous quarter's average, while the decline in imports of consumer goods was limited. Domestic sales of automobiles and home appliances grew robustly. Loans, on the other hand, remained on a modest upward track. The weak consumer confidence was a limiting factor on consumer spending in this quarter. While the production of machinery-equipment, an indicator for investments, fell slightly, its imports increased significantly. Mineral production and construction employment, variables related to construction investments, have registered some recovery. The investment trend that improved from the first half of 2014 contains positive signals for investments. Against this background, private domestic demand is believed to have increased moderately in the fourth quarter.
9. External demand indicators suggest that net exports did not contribute to growth in the fourth quarter of 2014. The slowing growth rates across Turkey's major trading partners and geopolitical tensions dampened export growth, while the modest recovery in domestic demand led to an increase in import demand. Thus, there has been no improvement for the fourth quarter of 2014 in the rebalancing process based on goods excluding gold. However, the favorable developments in the terms of trade and the moderate course of consumer loans contribute to the improvement in the current account balance.
10. Data available for the first quarter of 2015 indicate that the fourth-quarter outlook will persist. January's PMI and February's Business Tendency Survey (BTS) indicators point to no acceleration in production. The increased volatility in financial markets

and the weak consumer confidence restrain domestic demand. Moreover, external trade data for January show that exports remain weak due to external demand.

11. According to seasonally adjusted data, unemployment picked up in November 2014 due to sluggish nonfarm employment. Construction employment has been recovering since August, yet the recent growth in industrial employment has been balanced off by a decline. The services sector has continued to contribute to nonfarm employment. PMI and BTS survey indicators that reflect actual and expected employment figures for firms remain elevated as of January 2015 and signal no additional worsening for industrial employment. However, the limited increase in industrial production suggests that risks are on the downside for industrial employment. As of January 2015, indicators for the labor market point to a weak employment growth and a stagnant unemployment rate.

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. The annual growth rate of commercial loans is quite strong relative to that of consumer loans. This loan composition 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 limits the growth of exports. Yet, domestic demand may see some gradual recovery, also with the income effect of lower oil prices. In sum, external demand remains weak while domestic demand contributes to growth moderately. Thus, the growth composition may change in favor of domestic demand in the upcoming period. This change in the growth composition might lead to a widening in the non-energy current account deficit to some extent but the overall current account deficit is expected to narrow further down thanks to the improvement in the energy trade balance.
14. Downside risks regarding economic activity continue to be important for the upcoming period. The lingering volatility across global financial markets and the sluggish course of confidence indices may cause private final demand to provide limited support to growth. In the 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 ongoing cautious monetary policy along with prudent fiscal and macroprudential policies are having a favorable impact on inflation, especially on inflation excluding energy and food (core inflation indicators). In this regard, the Committee anticipates

that core inflation will continue to decline. Moreover, lower level of commodity prices, particularly oil, continue to support disinflation. However, the recent volatility in oil prices and exchange rates might limit the support provided by energy group to disinflation. Meanwhile, food prices may see some volatility, especially in unprocessed food, due to weather conditions.

16. Having the foreseen decline in inflation to be more persistent is important for maintaining the progress made in inflation over the last decade. A persistent decrease in inflation will contribute to the fall in long-term real interest rates by leading to declines in risk and inflation premia. These developments will have a favorable impact on public balance and potential growth. In this context, a more persistent reduction in inflation necessitates a cautious approach in monetary policy. Taking into account the heightened volatility in food and energy prices, the Committee cut the interest rates but with a cautious approach kept the rate cuts at a measured scale. Future monetary policy decisions will be conditional on the 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.
17. Global financial markets continue to follow a volatile course. The ongoing uncertainty about global monetary policies cause the global risk appetite and capital flows to be data-sensitive. The Federal Reserve's (Fed) policy normalization process and the European Central Bank's new quantitative easing program have been major factors affecting financial markets. The Committee emphasized that the CBRT has a rich set of policy tools to use against an earlier-than-expected policy rate hike by the Fed. Yet, higher risk of deflation in developed countries increases the probability of postponement in the normalization of monetary policies. The Committee pointed out that, in an environment of continued uncertainty over global financial markets and economic activity, prudential borrowing is crucial to limit the accumulation of macro-financial risks.
18. 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.
19. The Committee welcomed the development that the Medium Term Program incorporates disinflation as one of the main objectives. Moreover, it was indicated that the implementation of the announced structural reforms would contribute significantly to potential growth. 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.