TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 21 October 2015

Inflation Developments

1. In September, consumer prices increased by 0.89 percent, and annual inflation rose by 0.81 points to 7.95 percent. Annual food inflation remained on an upward trend as it did in previous month. Meanwhile, the depreciation in the Turkish lira pushed annual inflation in energy and core goods upwards. Annual services inflation, on the other hand, slowed somewhat, yet maintained its high levels. In this period, annual inflation of core indicators and their seasonally adjusted underlying trend increased due to the core goods prices.
2. Annual inflation in food and non-alcoholic beverages rose by around 1 point to 10.73 percent in September. This rise was led by unprocessed food inflation that reached 13.23 percent annually driven particularly by the prices of fresh fruits and vegetables, most notably fruits. On the processed food front, the monthly price increase proved lower than the last two months with 0.63 percent and the downward trend in annual inflation continued. Leading indicators of October show that annual food inflation may decline due to the unprocessed food prices. Energy prices went up by 0.53 percent and amid the depreciation in the Turkish lira, the annual energy inflation rose by around 0.7 point to 1.95 percent in September.
3. Prices of services rose by 0.79 percent in September, and annual services inflation edged down by 0.11 points to 8.54 percent. In this period, annual inflation increased in communication and other services, but decreased in transport and the restaurants-hotels groups. Due to the lagged effects of oil prices, annual transport service inflation maintained its slowing trend. Meanwhile, the course of food prices continued to have a negative effect on the restaurants-hotels group. Against this background, the underlying trend of services inflation exhibited an almost flat course in September maintaining its high level.
4. Annual core goods inflation rose by 1.37 points to 7.94 percent in September. Cumulative depreciation in the Turkish lira has adversely affected prices in the core goods group, especially the durable goods in this period. Accordingly, prices of

durable goods increased by 2.68 percent on a monthly basis, and price hikes particularly in automobiles and home appliances stood out. Moreover, prices of core goods excluding clothing and durables, where the exchange rate effects are observed with a relatively longer lag, also recorded an upsurge on a monthly basis. Thus, seasonally-adjusted indicators show a notable deterioration in the underlying trend of core goods inflation. October indicators point that exchange rate pressures 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. In August, industrial production increased by 2.9 percent month-on-month, rising above the second-quarter average by 0.7 percent in the July-August period. However, current data signal a weak outlook for September's industrial production. The 3 nonworking days due to the Feast of Sacrifice in September is expected to translate into a sharp drop in the annual percentage change of the raw data. BTS, PMI and export indicators also point to a weaker industrial production for September. Yet, in quarterly terms, industrial production is likely to post a moderate growth in the third quarter.

7. In the first half of the year, external demand remained weak, while contribution to growth came mainly from domestic demand. Data on the expenditure side suggest a more moderate demand outlook in the third quarter relative to the first half of the year. During the July-August period, the production of consumption goods declined. The imports of consumption goods, on the other hand, remained flat on the back of rising imports of automobiles despite the fall in most of the other subcategories. In the third quarter, sales of automobiles and home appliances were slightly down quarter-on-quarter. Consumer confidence indices continued to weaken in September. During the July-August period, the production of non-transport capital goods increased whereas their imports dropped. Indicators for the construction industry do not point to a robust recovery in construction activity, while firms' expectations for future investments remain low.

8. The non-gold exports volume index is expected to increase in the third quarter whereas the imports index may decline in line with the weakening domestic demand. The growth composition is expected to shift gradually towards net exports over the upcoming period thanks to a rising demand from the EU countries. This composition change and the favorable developments in the terms of trade along with the moderate course of consumer loans support the improvement in the current account balance. Data for September and October indicate that the marked August improvement in the current account balance continues recently.

9. In July, unemployment rates came down due to nonfarm employment growth. Services employment continued to make a sustained contribution to employment growth, while construction employment picked up after having fallen since the first quarter. Thus, the average annual employment growth equaled 3.4 percent for the January-July period. Industrial production and survey indicators suggest that industrial employment, which posted a modest increase in the first half, may fail to contribute to nonfarm employment growth in the third quarter. Being considered with other leading indicators, a moderate employment growth outlook is expected to continue in the upcoming period.

10. To sum up, current indicators suggest that domestic demand is likely to be more moderate in the forthcoming period than in the first half of the year, while external demand might see some recovery. Uncertainties in global markets and the weak course of confidence indices add to the downside risks to the growth and employment outlook, yet the rebalancing in the growth composition supports the improvement in the current account balance. Against this background, aggregate demand conditions are likely to support disinflation.

Monetary Policy and Risks

11. The Committee evaluated the medium-term forecasts to be presented in the October Inflation Report. In the third quarter, inflation surpassed the forecast of July Inflation Report due to food prices and exchange rate changes. Unprocessed food inflation increased, while core inflation remained high amid cumulative depreciation of the Turkish lira. Based on the assumptions underlying inflation forecasts and the external conditions, the end-2015 inflation forecast is revised upward in view of revisions to import prices and the exchange rate-driven upsurge in core inflation. Inflation is expected to hover around current levels for some time due to the effects of the exchange rates and start declining afterwards.

12. Energy price developments continue to affect inflation favorably. The negative impact of cumulative exchange rate developments since early 2015 on the inflation outlook is partly offset by lower oil prices. Food prices, on the other hand, remain volatile mainly due to unprocessed food prices, which poses both upside and downside risks to the year-end inflation forecast. The cumulative Turkish lira depreciation caused the annual core goods inflation to rise and the core inflation to deteriorate slightly. However, the tight monetary stance and the moderate domestic demand limit the exchange rate pass-through to prices compared to similar periods in previous years. Accordingly, 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. Future monetary policy decisions will be conditional on the inflation outlook. Taking into account inflation expectations, pricing behavior and the course of other factors affecting inflation, the tight monetary policy stance will be maintained.

13. 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 caused by recently increased domestic and external uncertainties. Specifically, commercial loans denominated in foreign currency and consumer loans have lost significant momentum. With respect to the composition of loans, commercial loans continue to grow faster than consumer loans. This composition not only limits medium-term inflationary pressures, but also helps to improve the current account balance. In addition to the moderate economic activity, rising loan rates and the tightening of other financial conditions also signal that loan growth may remain lower than past years' averages in the upcoming period.

14. Final domestic demand was the main driver of growth in the first half of 2015, while external demand remained weak. Indicators for the third-quarter point to a moderate economic activity, whereas the composition of growth hints at a slight slowdown in domestic demand and a recovery in exports. The weak consumer confidence and tighter financial conditions curb private consumption and investment demand. The slowing domestic demand and the changes in real exchange rates drive imports lower. On the exports front, despite the negative impact of geopolitical developments, the rising demand from EU members affects Turkey's exports positively. Against this background, the Committee expects the growth composition to shift gradually in favor of net exports in the upcoming period. This shift is expected to have a positive impact on the current account balance. Moreover, the favorable developments in the terms of trade and the sluggish course of consumer loans contribute to the improvement in the current account balance. Accordingly, the improvement in the current account balance which became evident with the August figures is expected to continue.

15. Uncertainties surrounding global monetary policies and concerns over global growth cause financial markets to remain volatile. Thus, portfolio flows to emerging economies and risk indicators follow a highly volatile pattern. The Committee stated that the measures announced by the CBRT within the context of the "road map during the normalization of global monetary policies" boost the resilience of the economy against global shocks. The current monetary policy stance is tight against the inflation outlook, stabilizing for the FX liquidity, and supportive of financial stability.

16. In case that the decline in loan growth rates become permanent and exchange rates continue to face upward pressure over the upcoming period, in addition to preserving the tight monetary policy stance, the Committee may take measures to support the Turkish lira and loan growth by easing the conditions for the use of foreign currency denominated collateral.

17. 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.

18. 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.