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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 23 July 2015

Inflation Developments

1. In June, consumer prices decreased by 0.51 percent, bringing annual consumer inflation down by about 0.9 points to 7.20 percent. With the ongoing correction in food prices, the decline in annual food inflation became more pronounced. Changes in crude oil prices drove energy inflation lower, yet the depreciation of Turkish lira constrained the disinflation. Core goods inflation was slightly up due to exchange rate effects while services inflation remained elevated. Thus, both the annual inflation and the underlying trend of core inflation indicators followed a flat course.
2. Annual inflation in food and nonalcoholic beverages was down by 3.54 points in June to 9.28 percent. This decline was largely caused by unprocessed food prices, while annual processed food inflation continued to slow. May's fresh fruit and vegetable-driven drop in seasonally-adjusted unprocessed food prices continued into this period at a stronger pace thanks to increased supply. However, red meat prices remained on the rise, affecting inflation negatively in associated categories such as processed food and catering services.
3. After an upsurge since February, energy prices decreased by 0.17 percent in June, bringing annual energy inflation down by 0.6 points to 2.78 percent. The fall in energy prices was mostly attributed to bottled gas and fuel prices, while indicators for July point to a continued decrease in energy prices.
4. Prices of services were up 0.88 percent in June while annual services inflation remained unchanged at 8.85 percent, mostly due to restaurants-hotels and other services. Annual inflation in rents and transport, on the other hand, decreased. Despite the significant correction in food prices over the past two months, annual restaurants-hotels inflation remained on the rise amid the ongoing upsurge in red meat prices. Meanwhile, annual inflation in the subgroup of other services increased due to rising prices of package holidays. As a result, underlying trend of services inflation remained flat at an elevated level.

5. Annual core goods inflation increased by 0.09 points to 5.97 percent in June. Annual inflation was up in durable goods due to base effects but down in other main categories. The substantial April-May price hikes were replaced by a slowdown in June across categories where exchange rate pass-through to prices is relatively faster, such as home appliances and automobiles. Prices of automobiles increased only modestly, while prices of furniture and electric/nonelectric appliances went down. On the other hand, core goods excluding clothing and durable goods continued to reflect the effects of cumulative depreciation in the Turkish lira. Hence, underlying trend of core goods inflation registered a small increase in June.

Factors Affecting Inflation

6. Industrial production declined by 2 percent in May on a monthly basis. This fall stemmed mainly from the production loss led by strikes in the automotive sector. The lowering effect on industrial production of the contraction in the production of vehicles is expected to be compensated for in the coming months. On a quarterly basis, the production level in the April-May period is 1 percent higher than the average production in the previous quarter. Assessing the PMI and BTS data together, a strong rebound is not expected in industrial production in the second quarter.
7. Data on the expenditure side suggest that production and imports of consumption goods increased in the April-May period compared to the average of the previous quarter. Domestic sales of home appliances recorded an uptick in this period. Likewise, sales of automobiles in the second quarter stood above the first-quarter average. Consumer confidence, on the other hand, continued to weaken due to geopolitical risks and uncertainties in global markets. Among investment indicators, production and imports of machinery-equipment posted a decline in the April-May period in comparison to the average of the previous quarter. Production and imports of mineral products, among the indicators for construction investment, registered an increase in the same period. Construction employment remained flat in April. Investment tendency maintained its sluggish course in the second quarter of 2015. Accordingly, domestic private demand is expected to contribute to growth moderately in the second quarter.
8. Following the contraction in the first quarter, the export quantity index excluding gold increased at a modest rate in the April-May period compared to the previous quarter, while the import quantity index excluding gold maintained its upward trend. This suggests that the contribution of external demand to growth may be limited in the second quarter. The weak course of the global economy and the ongoing geopolitical developments put a cap on export growth. On the other hand, 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.
9. In April 2015, total and non-farm unemployment rates fell by 0.1 and 0.2 points, respectively. Employment in non-farm sectors rose while the increase in labor force

was limited, leading to a decline in the unemployment rate. Employment in the industrial and services sectors rose, while construction employment fell in this period. Since the last quarter of 2014, non-farm employment growth has been driven by the services sector, while the industrial and construction employment have fluctuated around a flat trend. The industrial production and survey indicators suggest that the contribution of industrial sector to employment will be limited also in the upcoming period. Services employment is anticipated to grow at a slower pace in the upcoming period owing also to the stagnant tourism sector. Accordingly, unemployment is not expected to record a notable decline in the rest of the year. The current course of economic activity and the weakening investment tendency pose downside risks to employment.

10. In sum, data on the second quarter of 2015 suggest a mild course in economic activity. External demand remains weak while domestic demand contributes to growth moderately. Meanwhile, geopolitical risks and uncertainties in global markets besides the weak course of consumer and investor confidence pose some risks to growth in the upcoming period

Monetary Policy and Risks

11. The Committee assessed the medium-term projections to be presented in the July Inflation Report. Inflation in the second quarter proved close to the forecasts of the April Inflation Report, while core inflation stood above the projections. In this period, the fall in food inflation became the main driver of the improvement in inflation, while core inflation rose mostly because of the exchange rate effects. Analyzing the assumptions and external conditions that underlie the inflation forecasts, the end-2015 inflation forecast is revised slightly upwards in view of the developments in import and food prices besides the rise in core inflation driven by the exchange rate. The Committee assesses that that the partial recovery in food prices accompanied by the cautious monetary policy will limit the deterioration in the inflation outlook and inflation will reach the target in the medium term.

12. Unprocessed food inflation had been quite unfavorable in the first quarter, leading inflation to post high figures. However, recently there has been a notable correction in food prices, which has affected inflation favorably. Similarly, the recent decline in oil prices supports disinflation. On the other hand, exchange rate movements have been especially influential in the core goods group, delaying the recovery in the core inflation trend. This delay, combined with the uncertainty in global markets and volatility in energy and food prices, makes it necessary to maintain the cautious stance in monetary policy. The Committee has therefore decided to keep the interest rates at current levels.

13. Future monetary policy decisions will be conditional on the pace of improvements in the inflation outlook. Inflation expectations, pricing behaviors and other factors affecting inflation will be monitored closely and the cautious monetary policy stance will be maintained by keeping the yield curve flat, until there is a significant

improvement in the inflation outlook. Besides the cautious monetary stance, additional foreign exchange liquidity measures may be adopted, if exchange rate movements continue to delay the fall in inflation.

14. Loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. Commercial loans have recently been following a robust course of growth, while consumer loans lost pace due to the items excluding housing. Additionally, commercial loans grow faster than consumer loans in line with the desired loan composition. Owing also to the recent partial tightening in financial conditions, total credit growth is expected to slow somewhat in the second half of the year. This loan outlook not only limits medium-term inflationary pressures, but also contributes to the improvement in the current account balance.

15. External demand remains weak while domestic demand contributes to growth moderately. Although the recovery in the European economy affects the external demand positively, ongoing geopolitical developments and the slowdown in global trade restrict the export growth. Meanwhile, cumulative energy imports will continue to decline if the current low levels of oil prices are maintained. As a result, favorable developments in the terms of trade and the mild course of consumer loans support the recovery in the current account balance, yet the relatively weak export outlook limits this recovery. Domestic demand, on the other hand, exhibits a mild increase driven mainly by consumption. Meanwhile, the weak course of confidence indices coupled with domestic and external uncertainties are the risk factors that may restrict the contribution of the final private demand to growth. In this context, it is projected that the recovery in economic activity will be gradual, and the aggregate demand conditions will continue to support disinflation.

16. Risks to global markets remain significant. Reduced predictability of the 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 underlined that, besides cyclical policies to stabilize capital flows, structural measures to enhance the resilience of the financial system are important as well. Accordingly, recent measures implemented to support the FX liquidity, core liabilities, and long-term borrowing have enhanced the resilience of the economy against global shocks. The Committee has stated that additional measures along these lines may be adopted if deemed necessary.

17. Following the global crisis, especially during the exit process of the US monetary policy, long-term rates in emerging economies have grown excessively sensitive to global monetary policies. The wide interest rate corridor and the tight liquidity policy implemented by the CBRT increased the resilience of our economy against global shocks during this period. In the upcoming period, following the start of normalization of global monetary policies, volatility in long-term interest rates may

decline permanently thanks to forward guidance policies. According to this baseline scenario, the need for a wide interest rate corridor in our country may diminish over time. In that case, the operational framework of the CBRT's interest rate policy may be simplified gradually. Members of the Committee asked the technical departments to complete the preparations in this direction and to present them in August meeting.

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 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. 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.