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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 24 November 2015

Inflation Developments

1. In October, consumer prices increased by 1.55 percent, and annual inflation edged down by 0.37 points to 7.58 percent. Annual food inflation declined on account of the unprocessed food prices, while the annual energy inflation decreased due to the base effect. Meanwhile, the depreciation in the Turkish lira pushed annual inflation in core goods upwards. Annual services inflation, on the other hand, maintained its high levels. Accordingly, annual inflation of core indicators and their seasonally adjusted underlying trend registered increases.

2. Annual inflation in food and non-alcoholic beverages declined by around 2 points to 8.69 percent in October. This decline was led by annual unprocessed food inflation that receded to 9.40 percent driven particularly by the prices of vegetables. On the processed food front, the downward trend in annual inflation continued. Leading indicators of November show that annual food inflation may increase due to the unprocessed food prices. Energy prices went up by 0.77 percent while the annual energy inflation decreased by around 1.8 points to 0.12 percent due to base effect in October.

3. Prices of services rose by 0.71 percent in October, and annual services inflation edged up by 0.11 points to 8.65 percent. Annual inflation decreased in the restaurants-hotels group, remained flat in rent and increased in other services. Meanwhile, prices of catering services maintained the upward trend and the annual inflation in this group, with 14.87 percent, remained as the determinant of the high course of prices of services. Against this background, the underlying trend of services inflation exhibited an almost flat course in October maintaining its high level.

4. Annual core goods inflation rose by 1.25 points to 9.19 percent in October. The cumulative depreciation in the Turkish lira pushed the prices of core goods by 1.75 percent on a monthly basis. Witnessing the exchange rate effects with a longer lag, the annual inflation in core goods excluding clothing and durables reached 8.49 percent. Moreover, the clothing group recorded the highest October price increase of

the index history. Accordingly, seasonally-adjusted data showed a sustained increase in the underlying trend of core goods inflation.

5. In sum, the Monetary Policy Committee (the Committee) assessed that developments in energy prices continue to affect inflation favorably, yet cumulative effects of the exchange rate movements delay the improvement in the core inflation trend.

Factors Affecting Inflation

6. After the sharp monthly increase in August, industrial production remained flat in September, thus recording a quarterly growth of 1.1 percent in the third quarter. Due to fewer working days in September, industrial production declined by a yearly 7.9 percent, yet it might pick up again year-on-year thanks to October's increased working days. The BTS data on production over the last three months and the PMI indicators point to a moderate monthly growth for October. Industrial production has become increasingly volatile due to bridge days and the changing number of working days. Yet, seasonally and calendar adjusted three-month averages suggest that production remains on the rise.

7. Data on the expenditure side suggest a more moderate demand outlook in the third quarter relative to the first half of the year. The production and imports of consumption goods declined in the third quarter. The retail sales volume index slowed quarter-on-quarter, while non-food retail sales posted a quarterly contraction in the third quarter. After a robust second-quarter, imports of investment goods were down in the third quarter on a quarterly basis. Data on construction employment and the production and imports of minerals indicate a stable pattern in construction investments. All in all, domestic demand is likely to provide a modest contribution to growth in the third quarter.

8. The non-gold exports volume index rose in the third quarter whereas the imports index fell in line with moderate domestic demand. Therefore, the growth composition appears to be shifting in favor of net exports thanks to the 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. Recent data indicate a marked improvement in the seasonally adjusted current account balance. Thus, the current account balance in annual terms is expected to improve further.

9. Among BTS indicators, export orders over the last three months have seen expectations grow increasingly optimistic since early third quarter, while domestic orders have recovered recently after the weak course of the first three quarters. Moreover, the consumer confidence increased notably amid lessening domestic uncertainty. Likewise, expectations for investment and employment continued to improve. Against this background, confidence and revenue channels are expected to boost domestic demand in the upcoming period.

10. Non-farm unemployment remained flat in August due to the falling labor force participation, while non-farm employment decreased. By sectors, employment picked up slightly in services and construction but declined in the industrial sector for the third period in a row. Thus, the average annual non-farm employment growth equaled 3 percent in the January-August period. Having trended upward for the first three quarters, industrial production is expected to remain on the rise through the rest of the year. Survey indicators for industrial employment also point to a recovery in September and October. Accordingly, the fall in industrial employment is likely to be temporary. Given the economic outlook, the modest growth in services and construction employment is expected to continue.

11. To sum up, domestic demand appears to follow a more moderate course in the second half of the year, while external demand makes an increased contribution to growth. The recovery in European economy affects external demand positively, whereas geopolitical tensions pose a downside risk to external demand. Meanwhile, the reduced domestic uncertainty drives consumer confidence and expectations of investment and employment higher, which are expected to help to support the recovery of domestic demand over the upcoming period. Hence, aggregate demand conditions are likely to provide further support for disinflation.

Monetary Policy and Risks

12. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. Yet, loan growth has seen some deceleration recently. Specifically, commercial loans denominated in foreign currency and consumer loans have lost significant momentum. The Committee expects loans to return to the moderate growth path amid normalized financial conditions over the upcoming period. 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.

13. Indicators for the second half of the year point to a moderate economic activity. Industrial production continued to grow in the third quarter as well after the first half of the year. In this period, the non-gold exports volume index increased whereas the imports index fell. The rising demand in the European economy affects Turkey’s exports positively while geopolitical developments put downward pressure on external demand. Both the recent recovery of the confidence index and the improving expectations for investment and employment are likely to bolster domestic demand. Accordingly, the Committee assesses that the growth composition has shifted in favor of net exports. In addition to this shift, the favorable developments in the terms of trade and the sluggish course of consumer loans contribute to the improvement in the current account balance. Given the recent notable improvement in the seasonally-adjusted current account balance, the annual current account deficit is expected to narrow further.

14. Energy price developments continue to affect inflation favorably. The negative impact of cumulative exchange rate developments since the beginning of the year 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. The cumulative Turkish lira depreciation caused the annual core goods inflation to rise and the core inflation trend to deteriorate slightly. Thus, considering the impact of the global market uncertainty on inflation expectations and the volatility in energy and unprocessed food prices, the Committee stated that the tight liquidity stance will be maintained as long as deemed necessary. Future monetary policy decisions will be conditional on the inflation outlook. Taking into account inflation expectations, the pricing behavior and developments in other factors affecting inflation, the tight monetary policy stance will be maintained.

15. Uncertainties surrounding global monetary policies and concerns over global growth cause financial markets to remain volatile. Therefore, portfolio flows to emerging economies follow a volatile pattern. Despite having improved somewhat recently, risk premia and exchange rate volatilities remain high. 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 continues to be tight against the inflation outlook, stabilizing for the FX liquidity, and supportive of financial stability.

16. In case the decline in loan growth rates becomes 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 the 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.