TÜRKİYE CUMHURİYET MERKEZ BANKASI

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## SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 18 August 2015

***Inflation Developments***

1. In July, consumer prices increased by 0.09 percent while annual inflation was down 0.39 points to 6.81 percent. Annual food inflation was flat month-on-month whereas falling oil prices brought annual energy inflation down. Services inflation declined while core goods inflation rose slightly due to exchange rate pass-through. The underlying trend of core inflation displayed a slight improvement.
2. Annual inflation in food and nonalcoholic beverages remained flat at 9.25 percent in July. Annual inflation was slightly up in unprocessed food but continued to slow in processed food. On the unprocessed food front, prices of fresh fruits and vegetables remained favorable, whereas meat prices continued to rise. Among processed food items, prices of bread and cereals continued to affect inflation favorably whereas prices of other items slightly accelerated.
3. Annual energy inflation decreased to 1.58 percent amid falling fuel prices driven by lower oil prices. With the ongoing plunge in oil prices in July, annual energy inflation is expected to slow further in August.
4. Prices of services were up 0.80 percent in July while annual services inflation dropped by 0.43 points to 8.42 percent. Amid higher meat prices, prices of catering services continued to soar in July. Annual inflation increased in rents and restaurants-hotels but fell in communication and transport items due to base effects. Overall, the underlying trend of services inflation posted a month-on-month improvement.
5. Annual core goods inflation increased by 0.09 points to 6.05 percent in July. Annual inflation was up in durable goods, down in clothing and flat in core goods excluding clothing and durables. Prices of durable goods reflected the pass-through effect from exchange rate movements. Thanks to the favorable course in clothing prices, the underlying trend of core goods inflation registered a fall.

***Factors Affecting Inflation***

6. The industrial production index increased strongly by 2.4 percent month-on-month in June. Accordingly, industrial production grew by 1.6 percent quarter-on-quarter and 3.9 percent year-on-year in the second quarter of 2015. The strong production growth in June does not signify an acceleration in economic activity and is rather a result of compensating for the output loss led by the May strikes in the auto industry and expediting production before Ramadan. In fact, leading indicators for July and August suggest that the industrial production might moderate in the second half of the year.

7. Data on the expenditure side indicate that private consumption demand expanded further in the second quarter while investments remained weak. Production and imports of consumption goods were higher in the second quarter compared to their averages in the previous quarter. Meanwhile, production and imports of capital goods excluding vehicles fell in the second quarter. Indicators for the construction industry do not hint at a recovery for construction activity. After declining dramatically in May amid strikes, domestic sales of automobiles registered month-on-month gains in June and July. Thus, having contributed substantially to consumption lately, sales of automobiles are believed to have supported consumption further in July. On the other hand, the PMI for the July-August period and the Business Tendency Survey order indicators for July do not signal a solid domestic demand. Likewise, consumer confidence indices remained weak in July. Firms' expectations for future investments increased slightly in July but remained sluggish. In sum, current indicators point to a moderate outlook for consumption demand yet signal no recovery for investments.

8. After the first-quarter decline, the non-gold quantity index, an indicator for external demand, posted a quarter-on-quarter increase in the second quarter. Non-gold imports, on the other hand, grew modestly in the second quarter. As a consequence, deterioration in the real rebalancing process since mid-2014 somewhat reversed in the second quarter of 2015. Amid lower energy prices, the current account balance is expected to improve further in the upcoming period. However, the relatively weak outlook of exports and the likely fall in tourism revenues may dampen this improvement.

9. In May, seasonally adjusted total and nonfarm unemployment rates climbed by 0.2 and 0.3 points month-on-month, respectively. Although employment continued to expand in nonfarm sectors, unemployment increased due to the rising labor force participation, which was flat for some time. Industrial and services employment grew in this period, whereas construction employment declined. Industrial employment expanded at a stronger pace than in previous periods, providing the biggest contribution to nonfarm employment growth. Industrial production and survey indicators suggest that the industrial sector will contribute mildly to

employment in the forthcoming period. The support from services was more limited due to the sluggish tourism industry. The contribution from the services industry to employment is expected to remain below early 2015 levels in the upcoming period. Thus, prospects for a robust employment growth are slim for the remainder of the year. The economic outlook and the waning investment tendency pose a downside risk to the labor market.

10. To sum up, in the second quarter, external demand remained weak while domestic demand contributed to growth moderately. Current indicators suggest a similar outlook for the July-August period. Yet, uncertainties in global markets and the weak course of consumer and investor confidence add to the downside risks to growth for the upcoming period.

***Monetary Policy and Risks***

11. Loan growth continues to expand at a reasonable pace in response to the tight monetary policy stance and macroprudential measures. Commercial loan growth remains robust while consumer loans continues to decelerate. Recent tightening in financial conditions is likely to have some slowing impact on loan growth in the upcoming period. Overall, the pace and the composition of loans limit medium-term inflationary pressures and contribute to the improvement in the current account balance.

12. Recent data releases signal no significant change in the macroeconomic outlook. The favorable developments in the terms of trade and the moderate course of consumer loans contribute to the improvement in the current account balance. 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. Domestic demand, on the other hand, exhibits a modest upward trend driven mainly by consumption.

13. Although available data point to an ongoing moderate growth for economic activity, recent developments necessitate close monitoring of forward-looking signals. Recently, rising risk premiums due to global and domestic uncertainty have led to a tightening in financial conditions. This, coupled with the already weak confidence indices, creates downside risks regarding the domestic demand for the second half of the year.

14. Committee members stated that the inflation outlook has not displayed the desirable improvement yet. Although processed food and energy price developments affect inflation favorably in the short run, the cumulative exchange rate movements since early 2015 delay the recovery in the core inflation trend. Against this backdrop, the Committee stated that a slightly tighter monetary policy stance might be necessary to counterbalance the upside risks to inflation.

15. The Committee indicated that the inflation outlook and the risks would be instrumental for the exact implementation of the monetary tightening. Due to the imminent economic slowdown, exchange rate pass-through to domestic prices will be more limited than implied by historical estimations. Moreover, falling commodity prices partly offset the exchange rate effect. Meanwhile, downside risks to global economy and domestic economic activity remain significant. Accordingly, the Committee agreed to adopt a flexible approach for the implementation of the monetary tightening at this point and follow the consequences closely to review the situation at the next meeting. In conclusion, given the uncertainty over domestic and global markets and the volatility in energy and food prices, the Committee decided to implement a tighter liquidity policy for as long as deemed necessary.

16. 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. The Committee also evaluated the strategy to be pursued before and after the global monetary policy normalization, and decided to implement policy measures in three dimensions: (i) interest rate and Turkish lira liquidity, (ii) FX liquidity, and (iii) policies regarding financial stability. It was concluded that, considering the current global and domestic circumstances, the policies need to be tight for the Turkish lira, stabilizing for the FX liquidity, and supportive for financial stability. The Committee decided to publish the related document on the website.

18. A significant of the meeting focused on the simplification of the monetary policy framework. The Committee suggested that monetary policy framework may be simplified by gradually narrowing the interest rate corridor during global monetary policy normalization. It was stated that, eventually one week repo rate will assume the role of policy rate and represent the stance of monetary policy.

19. The Committee underlined that structural measures to support financial stability are as important as the cyclical policies to stabilize capital flows. Accordingly, the published roadmap included measures to support the FX liquidity and to provide incentives for core liabilities and long-term borrowing. The Committee stated that the past measures on this front have already enhanced the resilience of the economy and that additional measures may further bolster these gains.

20. 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.

21. 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.