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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 24 January 2017

Inflation Developments

1. In December, consumer prices were up 1.64 percent, while annual inflation rose by 1.53 points to 8.53 percent. As stated in December's Summary of the Monetary Policy Committee Meeting, annual food inflation soared amid higher unprocessed food prices, while energy inflation continued to climb due to the outlook for exchange rates and oil prices. In addition, recent tax adjustments, particularly on tobacco, put a marked upward pressure on inflation. Moreover, the plunging Turkish lira drove the annual inflation and underlying trend of core indicators higher.

2. Annual inflation in food and non-alcoholic beverages surged by 2.10 points to 5.65 percent, largely due to unprocessed food prices rising amid adverse weather conditions and exchange rate developments. Annual processed food inflation remained virtually flat. Leading indicators for January signal a continued uptrend in annual food inflation on the back of unprocessed food prices. Energy prices increased by 2.15 percent in December, with the upswing spread across all subcategories due to soaring oil prices and the tumbling Turkish lira. Thus, annual energy inflation increased by a total of 5.70 points in the last four months to 8.67 percent. Leading indicators suggest that energy inflation has remained on the rise over January due to exchange rate changes.

3. Prices of services edged up by 0.38 percent, while annual services inflation rose by 0.17 points to 8.11 percent in December. Annual inflation decreased in transport, remained almost flat in communication and went up in other subcategories. The slowdown in domestic demand and the sluggish tourism industry spilled over into prices of services, while several subcategories reflected the effects of the Turkish lira depreciation.

4. Annual core goods inflation inched up by 0.84 points to 6.77 percent in December. Annual inflation decreased in clothing, but increased in other subcategories. Among durables goods, all subcategories, home appliances in particular, saw considerable price hikes. Automobile prices were affected by the SCT hike, along with exchange

rate developments. The depreciation in the Turkish lira was evident in core good prices in December despite restrictive domestic demand conditions.

5. Although aggregate demand conditions put a downward pressure, inflation is expected to remain on an upward track in the short term due to the lagged exchange rate pass-through and volatile unprocessed food prices.

Factors Affecting Inflation

6. Recent data indicate that economic activity rebounded somewhat in the fourth quarter after the third-quarter deceleration. Despite a mild production growth across exporting industries, sectors with a relatively higher sensitivity to domestic demand weakened, causing industrial output to remain flat in November. Data on the production of electricity and vehicles and exports point to a modest growth in industrial output for December. Thus, industrial production is likely to post a quarterly gain in the fourth quarter thanks to the base effect coming from working day adjustment. However, apart from the technical recovery driven by working day effects, there is only a moderate recovery in economic activity which is not evenly spread across all sectors.

7. Current data indicate the external demand was more robust than domestic demand in the fourth quarter. Non-gold exports were up quarter-on-quarter in the October-November period, while non-gold imports edged down. Likewise, the PMI's new export orders rose above the neutral mark in the fourth quarter, while total orders posted a small quarterly gain. In this period, domestic sales of automobiles and home appliances were robust amid brought-forward demand, whereas the demand for services was on the decline, particularly in retail.

8. Economic activity is expected to recover further amid accommodative incentives and measures. The data on mortgage and auto markets accompanied by the recent recovery in consumer loans bolster the projections for a gradual improvement. Moreover, the public sector is expected to provide further investment support to growth in the coming months.

9. The growing EU demand continues to stimulate total exports, the auto industry in particular. Turkey's flexibility in diversifying markets continues to cushion exports against the negative effects of geopolitical tensions on external demand. Furthermore, the newly-restored relations with neighbor countries translated into a boost for exports. The sluggish outlook in tourism sector continues to have a negative impact on the current account balance, which, however, is alleviated by the lagged pass-through of terms-of-trade developments and the moderate course of loans. However, commodity prices are expected to gradually have a less of a positive influence on the current account deficit in the upcoming period.

10. The deterioration in the labor market, which began in May, continued through October. This period saw modest increases in services and industrial employment in contrast to a decline in the construction sector. Meanwhile, leading indicators such

as new job vacancies and unemployment insurance claims suggest that employment remains subdued and unemployment rates will continue to remain high.

11. In sum, economic activity slightly recovered in the fourth quarter and is expected to record a moderate growth in 2016. However, reverberations of recent market volatility through confidence channel, the potential impact of recent global and geopolitical developments on financial conditions and the lack of any signs of improvement in tourism outlook limit the pace of economic recovery.

Monetary Policy and Risks

12. Following the US elections in November 2016, global economic uncertainties intensified. In this period, long-term interest rates increased in advanced economies, while capital flows towards emerging economies subsided. The increased likelihood of the adoption of protective policies in the US following the elections poses a downside risk to the pace of growth and employment in emerging economies. In addition, the increased possibility of accommodative fiscal policies to be adopted by the US may lead to accelerated rate hikes by the Fed, which may result in further tightening of financial conditions in emerging economies.

13. Not only the ongoing uncertainties in global markets but also the geopolitical and domestic developments caused fluctuations in domestic financial markets in the fourth quarter of 2016. The adverse impact of these on financial conditions are partially counterbalanced through liquidity measures, macroprudential policies and other incentives. In fact, consumer loans and TL-denominated commercial loans have recently been signaling for recovery. On the other hand, tax arrangements done in the last quarter of the year, coupled with exchange rate developments led the demand for automobiles and durable goods to be brought forward at end-2016. Thus, the revival in consumer loans may lose some pace in the first quarter of 2017.

14. Recently-released data hint at a noticeable economic slowdown in the third quarter of the year. Thanks to the accommodative incentives and measures, domestic demand recorded an improvement in the last quarter. Nevertheless, sectoral diffusion of this improvement remained limited and underlying trend of economic activity registered a mild growth. Recent indicators suggest that the depreciation in the Turkish lira and the repercussions through confidence channel may lead to a slowdown in domestic demand in the first quarter of the year. However, as uncertainties and volatility in financial markets wane, the economy is expected to revert to its underlying trend in the ensuing period and display a moderate growth in 2017. On the other hand, the pace of recovery in tourism revenues, the global economic outlook, uncertainties regarding the monetary policies of advanced economies and geopolitical developments pose downside risks to the economic activity, while possible lagged effects of recent incentives and measures are considered as the upside risk factor. Retaining price stability as the main objective, the CBRT closely monitors also the reverberations of the downside risks to economic activity on financial stability.

15. The Committee evaluated medium-term projections to be presented in the January Inflation Report in the meeting. In the last quarter, inflation increased due to the energy, alcohol-tobacco and unprocessed food groups. Although aggregate demand conditions continued to be disinflationary, rises in the exchange rate and commodity prices increased the underlying trend of core inflation. In the short term, the base effect from unprocessed food prices and developments in the TL-denominated import prices are expected to drive inflation upwards significantly. Hence, it is projected that despite the restrictive effect of the mild course of aggregate demand, inflation will remain high for a while due to cost pressures, and display a gradual decline as of the second half of the year. Forecasts are based on the assumption that despite the tourism-induced slowdown in food demand and the support from the actions taken by the Food Committee, the base effect from unprocessed food prices, the probable effects of the adverse weather conditions on the food supply and the exchange rate developments will push the end-2017 food inflation upwards compared to the figures of the previous report. Accordingly, year-end inflation forecasts for 2017 and 2018 were revised upwards by 1.5 and 1 points, respectively compared to the October Inflation Report. Given a tight policy stance that focuses on bringing inflation down, inflation is likely to be 8 percent in 2017, 6 percent in 2018 and stabilize around 5 percent in 2019.

16. There are both downside and upside risks to inflation forecasts, yet upside risks to end-2017 inflation forecast seem more evident. Recently, the marked rise in foreign exchange market volatility poses an upside risk to inflation from expectations and pricing behavior channels as well as from the cost channel. On the other hand, the projected disinflationary effect of demand conditions may be higher, if economic activity recovers slower than expected in the period ahead. Risks to food inflation - another factor shaping forecasts- are considered to be balanced. Despite the possibility of food inflation to prove higher than expected still resides amid adverse weather conditions and the reverberations of the exchange rate, measures taken by the Food Committee are believed to counterbalance these risks. The CBRT will closely monitor the developments regarding inflation outlook and continue to take necessary policy measures to achieve price stability.

17. Against this background, starting from January 2017, the CBRT took a series of liquidity measures in response to the excessive exchange rate volatility and deterioration in the inflation outlook and decided to strengthen the tight monetary policy stance in the January MPC Meeting. In this respect, the marginal funding rate and the late liquidity window lending rate were hiked by 75 and 100 basis points to 9.25 and 11 percent, respectively. The CBRT will continue to use all available instruments in pursuit of the price stability objective. Future monetary policy decisions will be conditional on the inflation outlook. Inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and, if needed, further monetary tightening will be delivered. Moreover, necessary

liquidity measures will be taken in case of unhealthy pricing behavior in the foreign exchange market that cannot be justified by economic fundamentals.

18. The fact that the excessive volatility observed in the foreign exchange market in January 2017 was not accompanied by a change in macro framework or economic fundamentals, required a dynamic tightening practice inclusive of alternative liquidity instruments. While a simple policy framework enhances the effectiveness of transmission mechanism, it does not rule out these type of dynamic reactions.

19. Developments in fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The contribution of adjustments in administered prices to consumer inflation in 2016 was above historical averages. This emerged as one of the main determinants of higher inflation than the CBRT's forecasts issued at the start of the year. The baseline monetary policy stance for the upcoming period 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.

20. In recent years, sustaining fiscal discipline has become one of the major factors in reducing the sensitivity of the Turkish economy against external shocks. Moreover, the room provided by the fiscal discipline facilitates the countercyclical implementation of the fiscal policy in periods of slowing economic activity without a permanent deterioration in budget balances, as in 2016. Nevertheless, designing public spending and tax policies in a way that takes into account the subsequent effects on macroeconomic variables other than fiscal accounts such as growth, domestic savings and inflation, will contribute to the coordination of monetary policy and fiscal policy, and enhance macroeconomic stability.