TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 20 May 2015

Inflation Developments

1. In April, consumer prices increased by 1.63 percent and annual inflation rose by 0.30 points to 7.91 percent. This rise in annual inflation stemmed from the energy group, and particularly fuel prices. Inflation in food and related services maintained the high course, while the annual consumer inflation excluding food and catering services posted a slight increase, yet remained low. Annual core inflation indicators edged down again, whereas underlying trends thereof registered some increase in this period.
2. Annual inflation in food and non-alcoholic beverages rose by 0.24 points to 14.36 percent in April. This was mainly led by unprocessed food prices, the annual inflation of which hit 18.88 percent. Among the unprocessed items, fresh vegetables-fruits and meat stood out with an ongoing adverse outlook. On the other hand, annual inflation receded in processed food prices while monthly price increases were high in sub-items excluding bread. The contribution of food prices to annual inflation continued to rise and reached 3.51 points in April. Energy prices rose by 0.43 percent in April amid rising fuel and water prices, and the group's annual inflation reached 1.62 percent mainly due to the base effect.
3. Prices of services rose by 0.74 percent in April, and the annual services inflation edged up by 0.2 points to 8.74 percent. Cost pressures driven by food prices continued, while the effects of the recent volatility in exchange rates have been observed in the sensitive groups. The underlying trend of services has remained flat compared to the last month and stayed high.
4. Annual inflation of core goods decreased by 0.48 points to 5.06 percent in April. Annual inflation was down across all main categories, particularly clothing. Lagged effects of exchange rate developments proved apparent in monthly price developments. Accordingly, the underlying trend of core goods inflation recorded some increase.

5. To sum up, the ongoing cautious monetary policy stance along with domestic demand conditions continue to have a favorable impact on core inflation, whereas the recently-elevated volatility in exchange rates has limited the improvement in core inflation. Moreover, volatility in energy and food prices affects the consumer inflation adversely.

Factors Affecting Inflation

6. In March, seasonally and calendar-day adjusted industrial production grew by 2.2 percent month-on-month, recording a robust increase for the second month in a row. Thus, industrial production grew by 1.2 percent quarter-on-quarter and 1.3 percent year-on-year in the first quarter. Production developments have varied across industries. The weak external demand affected the textiles industry negatively while weather conditions dampened the other minerals industry, which is sensitive to construction activity. These developments drove the industrial production down by 0.4 points in the first quarter. However, the industries of vehicles, other transport vehicles, pharmaceuticals, and oil products added a total of 1.6 points to the quarterly growth.
7. Although industrial production increases solidly, survey indicators present a weaker outlook. The PMI production data have been hovering below 50 since the beginning of the year. The equilibrium value of the Business Tendency Survey (BTS) question about production over the last three months has been declining gradually since October 2014. Survey indicators for domestic and external demand confirm the weak course of exports and do not produce strong signals about domestic demand. Thus, PMI data on new orders and new export orders have remained below 50 since January. Orders over the last three months and three-month-ahead order expectations from BTS have been weakening in both exports and the domestic market. In sum, while industrial production grew robustly in the first quarter, in line with the weak production-related survey indicators since early 2015 it is assessed that the underlying trend in production remains moderate and economic recovery may exhibit a gradual path.
8. Data on the expenditure side point to an increase in private demand for the first quarter. In this period, the production and imports of consumer goods posted a quarterly growth, particularly faster for imports. After the January contraction, sales of home appliances were up month-on-month in February and March, signaling a positive outlook for private consumer demand. Meanwhile, the rapid increase in automobile sales that contributed significantly to the recent consumption growth continued into April. Among indicators for investment goods, the production and imports of machinery-equipment recorded a quarterly and yearly decline in the first quarter. Yet, the robust sales of light and heavy commercial vehicles hint at an improvement in investments. Hence, it is assessed that private demand continues to recover.

9. Data on production and sales offer a positive outlook for private demand, yet confidence indices point to downside risks. The consumer confidence has been weak for a long time. The BTS data on investment tendency and overall economic activity and TURKSTAT's confidence indices for retail trade, services, and construction sectors also show that expectations of firms have yet to begin improving. The lingering volatility in financial markets restrains the improvement of financial conditions. All these developments suggest that the recovery in private demand will be moderate and gradual.

10. In the first quarter of 2015, non-gold exports were down while non-gold imports were up from their past quarterly averages. This outlook is largely driven by exports that have been weaker than domestic demand due to the slowing growth across trading partners. Nevertheless, the favorable developments in the terms of trade and the moderate course of consumer loans contribute to the improvement in the current account balance.

11. In February 2015, total and nonfarm unemployment rates decreased by about 0.1 point. Compared with January, both labor and employment growth slowed across nonfarm sectors. Construction employment declined, whereas industrial employment remained flat. Having accelerated from previous periods, the employment growth in services was the major driver of nonfarm employment growth. The recently released industrial production and survey data show that employment might recover somewhat in the second quarter. Yet, the current path of economic activity and the weakening investment tendency pose downside risks to employment.

12. To summarize, external demand remains weak, while domestic demand contributes to growth moderately. The uncertainty over global markets and the weak course of consumer and investor confidence suggest that economic activity will remain moderate in the upcoming period. Based on this outlook, the aggregate demand conditions support disinflation.

Monetary Policy and Risks

13. Loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. The composition of loans also continues to evolve in the desired direction. Commercial loans grow at a faster pace than consumer loans. This loan outlook not only limits medium-term inflationary pressures but also contributes to the improvement in the current account balance. Moreover, the favorable developments in the terms of trade continue to support the improvement in the current account balance.

14. Industrial production gained some momentum in the first quarter partly owing to the thriving vehicle production. Consumer confidence and investment tendency point to a moderate private domestic demand, while leading indicators suggest that external demand is relatively weak. Recent signs of recovery in Europe might be a development that would boost the external demand. However, lingering volatility in

global financial markets and the weak course of confidence indices are the risk factors that may limit the contribution of the private final demand to growth. To sum up, external demand remains weak while domestic demand contributes to growth moderately. Thus, the recovery in economic activity is expected to be gradual and aggregate demand conditions are expected to continue supporting disinflation.

15. The ongoing cautious monetary policy along with prudent fiscal and macroprudential policies continue to have a favorable impact on inflation, especially inflation excluding energy and food (core inflation indicators). However, recently elevated volatility in the exchange rates has limited the improvement in the core inflation, as stated in the April Inflation Report. The moderate course of aggregate demand conditions and low levels of international commodity prices support disinflation but the recent fluctuations in energy prices curtail this contribution. Food prices, which are still at high levels, remain as the main risk factor for inflation. However, with the introduction of new seasonal products in summer months, food prices are likely to see a notable correction.

16. Global markets continue to follow a volatile course. Reduced predictability of 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 assessed that the measures taken to support the FX liquidity, core liabilities and long-term borrowing enhanced the resilience of the economy against global shocks. Additional measures along these lines may continue to be taken if deemed necessary.

17. In conclusion, the global market uncertainty and the unfavorable effects of the exchange rate volatility on core inflation coupled with the volatility in energy and food prices make it necessary to maintain the cautious stance in monetary policy. 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.

18. Developments on 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. The implementation of the announced structural reforms is expected to contribute significantly to potential growth. 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.