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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 23 August 2016

Inflation Developments

1. In July, consumer prices increased by 1.16 percent, and annual inflation went up by 1.15 points to 8.79 percent. As stated in the Summary of the Monetary Policy Committee Meeting of July, this rise was driven by prices of unprocessed food and tobacco products. Both annual inflation figures and the underlying trends of core indicators followed a flat course in this period.
2. Having surged in the last two months, annual inflation in food and non-alcoholic beverages climbed to 9.69 percent due to the prices of fresh fruits and vegetables. However, annual inflation in food items excluding fresh fruits and vegetables registered a decline. Agricultural prices also displayed a similar path, indicating that the rise in food inflation in this period stemmed from producer prices. On the other hand, leading indicators regarding August point out a downward correction in unprocessed food prices. On the energy front, prices fell by 0.40 percent on account of the decline in international oil prices. Thus, annual energy inflation maintained a low course with 2.40 percent.
3. Prices of services increased by 1.07 percent, and the annual services inflation rose by 0.30 points to 8.55 percent in July. Annual inflation increased in transport and communication services, but remained almost unchanged in other sub-groups in this period. Restaurants and hotels group also exhibited a high monthly rise in line with the high course of food inflation. Meanwhile, the monthly rate of increase in rents, which had been high for a while, slowed somewhat in July. As a result, the underlying trend of services recorded an increase in July. The surge in unit labor costs in the first quarter coupled with increased rigidities due to the prolonged high course of consumer inflation weigh on services inflation. On the other hand, the recent deceleration in economic activity may curb services inflation.

4. Annual core goods inflation edged down by 0.31 points to 8.82 percent in July, driven by durable goods. Prices of durable goods excluding furniture displayed a favorable outlook. Upon the lingering labor-driven cost pressures since the start of the year, cumulative price increases in the furniture group amounted to 8 percent in the first 7 months. The underlying core goods inflation posted a decline in July. However, the recent depreciation in the Turkish lira is expected to deteriorate the core goods inflation to some extent in the short term. Nevertheless, waning cumulative exchange rate effects are likely to pull annual core goods inflation further down in the upcoming period.

5. In sum, consumer inflation surged in the last two months owing to the unprocessed food prices. In addition, tobacco products saw price hikes in July as well. The impact of this rise will be seen also in August, albeit to a relatively limited extent. The Committee envisages that unprocessed food prices, which saw notable increases in the last couple of months, may display a downward correction in the short term. Meanwhile, core inflation is expected to sustain its gradual downtrend.

Factors Affecting Inflation

6. Data for the second quarter of 2016 indicate a slowing yet ongoing uptrend in economic activity. Adjusted for seasonal and calendar effects, the industrial production index decreased by 1.4 percent in June compared to May. Thus, following a robust quarterly increase of 1.4 percent in the first quarter, production declined by 0.6 percent in the second quarter. Despite the favorable figures in exports excluding gold, negative contribution of net exports to growth continued amid the rise in import demand coupled with the growing loss in tourism revenues.

7. Data on the expenditure side point to a modest course in final domestic demand in the second quarter. The production of consumer goods posted a decline on a quarterly basis, while that of investment goods remained flat. Retail trade sales index also exhibited an almost flat pattern, signaling a slowdown compared to the first quarter. Data regarding the third quarter indicate that the private sector demand may weaken compared to the first half of the year. In fact, July witnessed decreases in sales of automobiles, white goods and light commercial vehicles. Meanwhile, the new job posts and the PMI employment data also confirmed the signs of deceleration.

8. Although developments in tourism revenues will have a negative impact in the short run, the lagged effects of the developments in the terms of trade and the moderate course of consumer loans will continue to contribute to the improvement in the current account balance. The rising demand from the European Union countries continues to have a favorable effect on our exports. In spite of the persisting geopolitical risks, Turkey’s high market-shifting flexibility continues to support exports. Meanwhile, the favorable impact of commodity

prices on the current account deficit is expected to diminish gradually in coming months.

9. Seasonally-adjusted unemployment rates posted an increase in May 2016 compared to the previous period. In this period, non-farm employment growth posted a slowdown, pushing unemployment rates upwards. The prolonged uptrend in construction employment was interrupted to a limited extent, while industrial employment remained flat after a recovery in the March-April period, and the services employment picked up slightly compared to the past. The data from the Social Security Institution indicate that the stagnant tourism sector started to have spillovers on employment. Leading indicators signal a deceleration in employment growth in the short term.

10. To sum up, economic activity continues to grow at a moderate and stable pace. Domestic developments of July may cause a pause in this trend in the short term. However, this is not likely to be a permanent trend, as the recent measures contained the adverse impacts on the markets. On the other hand, the reduction in tourism revenues is expected to curtail the improvement in the current account balance, rise in employment and growth.

Monetary Policy and Risks

11. Financial conditions remain tight, while the moderate course of annual loan growth rates continue. Despite the recent rise in global risk appetite and capital inflows, the improvement in financial conditions is detained due to domestic developments. The gradual fall in the marginal funding rate spilled over into loan and deposit rates remarkably, yet loan-deposit spreads remain high, and loan standards exercised by banks have not eased. Moreover, the moderate course of final domestic demand also restricts loan growth. Given the demand and supply-side factors no noticeable rebound is envisaged in loan growth rates in the short term.

12. Economic activity maintains a moderate and stable course of growth. Consumption spending has slowed down slightly, while investment remains relatively sluggish. Meanwhile, the steady increase in employment and wage developments support domestic demand through the income channel. Despite the adverse effects of geopolitical developments on external demand, exports of goods to the European Union countries remain strong. Restored relations with Russia may also support external demand gradually. Accordingly, exports of goods are expected to provide further contributions to growth in the upcoming period. In this respect, economic activity is expected to show a moderate pace of growth across the year. Domestic developments in July, geopolitical factors, waning global growth and sluggish tourism sector pose a downside risk to economic activity. On the other hand, domestic confidence indices have not shown a sharp deterioration. This, together with the market-shifting flexibility of our exports put a limit on the downside risks.

13. The volatility in global financial markets has recently eased, and portfolio inflows to emerging markets gained momentum amid the increased risk appetite. The consequences of the mid-July turmoil in Turkey on financial markets were largely taken back thanks to the rise in the global risk appetite and the liquidity measures. The tight monetary policy stance, the cautious macroprudential policy and the effective use of the policy tools announced in the road map of August 2015 enhance the resilience of the economy against external shocks. Accordingly, the Committee decided to take one more measured step towards simplification by lowering the marginal funding rate.

14. The ultimate aim of simplification is to achieve a narrow and symmetrical corridor and provide funding via a single rate. Simplification is believed to contribute to the effectiveness of the transmission mechanism. Therefore, simplification of the monetary policy is planned to be finalized within a reasonable schedule. The pace and timing of simplification will depend on the developments regarding inflation and financial stability.

15. Pioneered by unprocessed food and tobacco products, inflation registered a notable increase in July, while core inflation indicators followed a flat course. Lagged effects of cumulative exchange rate movements eased further, underpinning the improvement in core goods inflation. However, pressures led by unit labor costs and food prices caused the underlying trend of the services inflation to remain high. In spite of the support from the low level of imported input costs, the improvement in the inflation trend has been limited. Growing signals for deceleration in domestic demand stemming from the latest domestic developments and the poor outlook in the tourism sector constitute downside risks to demand and inflation. Nevertheless, exchange rate movements and possible public price/tax adjustments keep the upside risks to inflation brisk. In this respect, developments regarding the inflation outlook necessitate the maintenance of the tight liquidity policy stance.

16. In the upcoming period, the monetary policy stance will be conditional on the inflation outlook. Taking into account inflation expectations, the pricing behavior and the course of other factors affecting inflation, the tight monetary policy stance will be maintained.

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 essential in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current

environment of highly uncertain global markets, the gains from maintaining and further advancing these achievements are significant. Any measure to provide permanent fiscal discipline and reduction in 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.