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SUMMARY OF THE MONETARY POLICY MEETING

Meeting Date: 25 September 2014

Inflation Developments

1. In August, consumer prices were up 0.09 percent and annual inflation increased by 0.22 points to 9.54 percent. This increase in annual inflation was driven primarily by prices of food and services groups. The contribution of food and catering services groups to annual inflation reached 4.4 percentage points in this period. The underlying trend of services inflation increased, whereas the improving trend in core goods became evident on the back of the fading cumulative effects of the depreciation in the Turkish lira.

2. Annual food inflation edged up to 14.44 percent. In August, annual inflation increased to 16.06 percent in unprocessed food and reached 13.15 percent in processed food. This increase has been determined by both supply-side constraints due to adverse weather conditions and the cumulative depreciation in the Turkish lira. Given this outlook, the group’s inflation bears the risk to remain elevated for a while.

3. Prices of services rose by 0.92 percent month-on-month, bringing annual services inflation up to 8.96 percent. In this period, annual inflation followed a rising trend across most subcategories of services. In tandem with food inflation, annual inflation in restaurants and hotels remained on the rise and reached 14.73 percent. Thus, having hovered around 8 percent since the start of 2014, services inflation rose approximately by 1 percentage points within the year. The underlying trend of services inflation continued with increasing figures, curbing the improvement in core indices.

4. Receding to 2.94 percent, the annual increase in energy prices contributed favorably to consumer inflation. However, the cumulative depreciation in the Turkish lira poses an upside risk to energy group inflation. Meanwhile, declining international energy prices in line with weakening global demand are thought to limit the upside risks.

5. Annual core goods inflation fell to 10.37 percent in August. Due to varying lags in the exchange rate pass-through among subcategories, annual inflation figures continued to decouple in sub-groups. Accordingly, annual inflation remained on the decline in durable goods, the prices of which have decreased since May, in contrast to the persisting rise in core goods excluding durables and clothing, which are affected by the exchange rate developments with a lag. Supported also by the higher-than-expected discount in clothing prices compared to recent years' averages, the seasonally adjusted data revealed a sustained improvement in the underlying trend in core goods inflation.

6. In sum, adverse effects of the cumulative depreciation in the Turkish lira since mid-2013 are gradually waning. However, the Committee assessed that elevated food prices continue to delay the improvement in the inflation outlook.

Factors Affecting Inflation

7. Second-quarter GDP data point to sluggish economic activity compared to the outlook announced in the July Inflation Report. In this period, the increasing sentiment of uncertainty due to international developments and the slowing global growth led to a weaker-than-expected performance for consumer demand and exports, respectively. On the other hand, net exports continued to make positive contribution to annual growth.

8. Third-quarter data show a moderate quarterly increase in economic activity. On the production side, the Industrial Production Index grew by 1.8 percent in July, both month-on-month and quarter-on-quarter. However, due to shifting holidays and the automotive industry's holiday scheme, production may experience some volatility in August and September, resulting in a more modest quarterly production growth.

9. Data on the expenditure side point to a moderate recovery in domestic private demand in the third quarter. In July, the production of consumer goods was higher than the second-quarter average. Among indicators for the durable-goods demand, imports of durable goods declined, whereas the July-August average for the production of durable goods and the sales of automobiles and home appliances

reveals a quarterly growth. The production and imports of investment goods excluding transport, an indicator for machinery-equipment investments, picked up. Among indicators for construction investments, the production of minerals decreased while their imports continued to rise. Meanwhile, data on July-August budget spending indicate that public demand might support growth in the third quarter.

10. Exports remain supportive of balanced growth in spite of weakening global demand. The non-gold export and import indices were up by a monthly 4.2 and 3.3 percent, respectively, in July. Indicators for August point to a fall in non-gold exports month-on-month due to geopolitical tensions and the automotive industry, and to a rise in non-gold imports. Geopolitical tensions and the waning global demand, particularly across Europe, are expected to put further pressure on external demand for some time. Thus, exports may provide less support to growth in the upcoming period than in the first half of the year.

11. In June, unemployment rates were higher quarter-on-quarter in seasonally adjusted terms. The rise in unemployment was largely due to a weaker non-farm employment. While labor force continued to grow, non-farm employment declined slightly during May-June because of losses in construction and industrial employment. On the other hand, services employment remains on the rise. Leading indicators for the third quarter point to a stagnant outlook for employment. The low levels of investment tendency and the moderate growth in industrial production suggest that a recovery in the labor market may take some time.

12. In sum, private demand is expected to recover modestly and gradually on the back of less tight financial conditions and waning domestic uncertainties. However, the weakening global demand, the uncertainty over global monetary policies and the lack of a strong and steady recovery in consumer and investor confidence add to the downside risks to growth.

Monetary Policy and Risks

13. The Committee stated that the recent growth rate and the composition of loans evolve in the desired direction, owing to the tight monetary policy stance and macroprudential measures. The annual growth rate of consumer loans remain at low levels, while commercial loan growth is relatively more robust. The current outlook in loans not only contains medium-term inflation pressures but also supports the improvement in the current account balance.

14. In line with these developments, the private sector demand is expected to follow a mild and gradual growth path after the slowdown in the second quarter. Exports, on the other hand, continue to support balanced growth in spite of the weakening global demand. Accordingly, it is believed that demand developments will not pose an upward pressure on inflation in the coming period, while supply-side factors will affect the course of inflation.

15. Macroprudential measures taken at the beginning of the year and the tight monetary policy stance started to have favorable impact on the core inflation trend. Having soared in early 2014, trend of core inflation indicators H and I have recently improved and most of the rise in inflation trend was taken back by August. Accordingly, the adverse impact of cumulative exchange rate developments on annual inflation is tapering off as well. The Committee highlighted that there is a considerable room for decline in inflation in 2015 through this channel. However, it was also underlined that second round effects and the recent volatility in exchange rates should be closely monitored.

16. Elevated food prices continue to delay the improvement in the inflation outlook. The Committee noted that domestic food prices have diverged negatively from international food prices in recent months. It is also suggested that the fall in commodity prices, driven by slowing global demand, might contain upside risks to inflation. The current elevated levels of inflation affect medium-term expectations adversely and boost risks related to pricing behavior. The Committee will closely monitor inflation expectations, pricing behavior and other factors that affect inflation and maintain the tight monetary policy stance by keeping a flat yield curve until there is a significant improvement in the inflation outlook.

17. Uncertainty regarding global monetary policies has continued to prevail in financial markets recently. While ending quantitative easing, the U.S. Federal Reserve stated that it would keep policy rates low for a considerable time. Moreover, the expectations of the level that policy rates will reach in the long run is lower than the pre-crisis level. In this context, the Committee was briefed on limits, interest rates and past implementations of Foreign Exchange and Banknotes Markets-Foreign Exchange Deposit Market. The European Central Bank has recently cut policy rates against the risks of economic slowdown and deflation and announced a quantitative easing program. Although such policies may lead to more capital flows into emerging markets, the volatility in capital flows persists.

18. For the purposes of financial stability, it is important to further strengthen the current healthy state of the banking sector. In this context, the Committee was

informed about the preparations on remunerating the Turkish lira portion of required reserves, on a basis to encourage improving the deposit and equity ratios of the banking sector.

19. The Committee closely monitors developments on the fiscal policy and tax adjustments with regard to their effects on the inflation outlook. The baseline monetary stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes on administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

20. Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improving social welfare by keeping interest rates of long-term government securities at low levels. In this respect, implementing the structural reforms required by the Medium Term Program remains to be of utmost importance.