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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 20 October 2016

Inflation Developments

1. In September, consumer prices went up by 0.18 percent, while annual consumer inflation fell by 0.77 points to 7.28 percent. As stated in the Summary of the Monetary Policy Committee Meeting of September, being driven by unprocessed food prices, the deceleration in food inflation continued. Moreover, weakening demand conditions also supported the disinflation process. On the other hand, the tax rise in fuel products curbed the improvement in inflation through direct and indirect effects. Core indicators' annual inflation declined while their underlying trends somewhat improved in this period.
2. Annual inflation in food and non-alcoholic beverages decreased by 2.03 points to 4.16 percent due mainly to the decline in prices of fresh fruits and vegetables. Meanwhile, inflation in food items excluding fresh fruits and vegetables maintained its favorable course. Leading indicators regarding October suggest some increase in food inflation. On the energy front, prices increased on account of rising taxes on fuel products. Annual energy inflation climbed to 4.56 percent. Recent developments in the exchange rate and international oil prices are envisaged to push October energy inflation upwards, yet this adverse effect is likely to be partly offset by the reduction in natural gas prices at the start of the month.
3. Prices of services increased by 0.89 percent, and annual services inflation inched up by 0.11 points to 8.19 percent in September. Annual inflation increased in transport services; remained flat in rent, and decreased in other sub-groups in this period. Inflation in the restaurant-hotel group decelerated further due to the favorable course of food prices stemming from the contraction in tourism, whereas prices of transport services witnessed an upsurge amid fuel price hikes. In this respect, the underlying trend of services inflation exhibited an uptick.
4. Annual core goods inflation fell by 1.70 points to 6.97 percent in September. Being more evident in durable goods, annual inflation decreased in all subgroups. The fall in core goods inflation is attributed to the waning cumulative effects of the

exchange rate coupled with the deceleration in domestic demand. Accordingly, the underlying trend in core goods exhibited a remarkable slowdown in this period.

5. In sum, the slowdown in aggregate demand contributes to the gradual fall in core inflation. However, exchange rate developments and other cost factors limit the improvement in inflation outlook.

Factors Affecting Inflation

6. Recent data releases and indicators for the third quarter point to deceleration in economic activity. The second-quarter plunge in industrial production has deepened due to the sharp drop in July. This output fall in July is largely attributed to the demand-side effects of the domestic turbulence as well as to the loss of working days caused by the Ramadan holiday and the incidents of July 15. In fact, industrial production recovered by a rapid 9.4 percent month-on-month in August, confirming that July's output loss was not a good indicator of the underlying trend. Both PMI indicators for new orders and output and the manufacturing industry capacity utilization rate edged upward in September. Notwithstanding the upbeat outlook suggested by survey indicators, production may see a renewed slowdown due to bridge-day effects caused by the extended holiday for the Sacrifice Feast in September, leading to a quarter-on-quarter decline in industrial production in the third quarter.

7. Domestic demand is expected to pick up by the fourth quarter amid accommodative incentives and measures. July's domestic tensions dampened final domestic demand to a great extent through both consumer and investment spending. In the July-August period, the production and imports of consumer goods and the consumption of durable goods were markedly down from the second quarter. On the investment front, data on the production and imports of machinery and equipment showed that investments remained weak over the third quarter. An indicator for construction activity, the production and imports of nonmetallic minerals declined, suggesting that construction investments slowed in the third quarter.

8. Recent data signal that domestic demand started to rebound in the fourth quarter. Consumer loans have inched up in recent months thanks to more accommodative monetary conditions and other measures in place, confirming expectations of an upturn for the final quarter. Restoration of producer and consumer confidence due to waning uncertainties and demand-stimulating policies will be the main drivers of economic recovery in the upcoming period.

9. Growing EU demand continued to bolster exports. Turkey's flexibility in market diversification continues to cushion exports against the negative effects of geopolitical tensions on external demand. Yet, recent data show that exports and imports of goods were largely affected by the July turbulence. Despite some recovery in August and September, trade of goods declined in the third quarter. Spillovers from the troubled tourism industry into net exports were more

pronounced in the summer months. The tourism slump continues to have a negative impact on the current account balance, which, however, is somewhat alleviated by the lagged pass-through of terms-of-trade developments and the moderate course of consumer loans. However, commodity prices are expected to become gradually less accommodative for the current account deficit in the coming months.

10. The deteriorating labor market outlook of May and June continued into July due to falling industrial employment, causing unemployment rates to remain on the rise. Employment gains in services lost more pace amid sluggish economic activity. Across non-farm industries, the previous quarter's decline in construction employment came to a halt. Additionally, according to the SSI data on registered employees, the employment fall in major tourism industries (accommodation, travel agents and tour operators) turned around in July. Moreover, the PMI for industrial employment signals no additional deterioration for September yet remains low. Given the weak economic activity and leading indicators for employment, unemployment rates are expected to climb further in the third quarter.

11. In sum, economic activity is expected to recede in the third quarter. However, domestic demand is envisaged to pick up in the upcoming period on the back of less uncertainty, restored producer and consumer confidence, incentives stimulating domestic demand and recovering consumer loans.

Monetary Policy and Risks

12. The Committee evaluated the medium-term projections to be published in the October Inflation Report. In the third quarter of the year, inflation recorded a decline on account of the improvements in unprocessed food and core inflation indicators. While the lagged effects of the cumulative exchange rate developments on annual inflation continued to wane, slowing aggregate demand supported disinflation and the underlying trend of core inflation improved. However, the tax rise in fuel products restrained the recovery in inflation through energy and transport prices. Although the developments in TL-denominated import prices are expected to push inflation upwards, the mild course of aggregate demand is projected to support the gradual decline in core inflation. Moreover, forecasts are based on the assumption that the year-end food inflation in 2016 and 2017 will be lower than the projections of the previous Report amid the tourism-induced slowdown in food demand and the actions taken by the Food Committee.

13. Accordingly, the year-end consumer inflation forecast for 2016 remained unchanged as downside and upside effects on inflation cancelled each other out. On the other hand, end-2017 consumer inflation forecast was revised upwards by 0.5 points as the upside effects driven by import prices outweighed the effects of the downward revision in the output gap and food inflation.

14. Overall financial conditions is buoyed by macroprudential arrangements and reduced tightness in monetary conditions thanks to the CBRT's policy actions. The

gradual fall in the marginal funding rate has partially passed through to loan and deposit rates. Supported also by the recently enforced macroprudential measures, consumer loans displayed recovery in the last couple of months. On the other hand, due to global and geopolitical developments that had effects on domestic financial markets, tightness in loan conditions has not witnessed a notable decline yet. As the downgrade of Turkey's sovereign credit rating to below investment grade at the end of September was largely anticipated by markets, the reaction of financial markets remained limited. Even though this downgrade weighs on external funding costs, loan conditions are supported by liquidity measures, macroprudential arrangements and other incentives. On the other hand, the CBRT may introduce accommodative adjustments to required reserves and other liquidity instruments in case of a higher-than-expected tightness in financial conditions.

15. The latest data indicate a significant slowdown in economic activity in the third quarter. Recent accommodative measures and incentives are projected to stimulate a rebound in domestic demand starting from the last quarter. Accordingly, economic activity is expected to register a mild growth in the remainder of 2016 and throughout 2017. However, the pace of the recovery in tourism revenues, the global economic outlook, the uncertainties regarding the monetary policies of advanced economies and geopolitical developments pose downside risks to economic activity. The CBRT will continue to monitor closely the impacts of the developments in economic activity on price stability and financial stability.

16. There are both upside and downside risks to inflation forecasts. Inflation may settle on a lower-than-expected path, should economic activity recover at a slower-than-envisioned pace in the upcoming period. On the other hand, uncertainties regarding oil prices and global markets pose an upside risk to inflation through the cost channel. Meanwhile, the volatility in food prices pose risks in both directions for 2017. The CBRT will closely monitor the developments affecting inflation and take necessary policy measures to achieve price stability.

17. Leading indicators for the third quarter of 2016 point to a mild improvement in global economic activity. However, due to the historically low levels of global growth and trade volume, interest rates in advanced economies remain low. Accordingly, risk appetite towards emerging economies has followed a robust course in recent months. On the other hand, uncertainties regarding global monetary policies cause fluctuations in portfolio inflows. In fact, amid strengthened perceptions about the Fed's possible rate hike coupled with the uncertainties regarding the monetary policies of other advanced economies, portfolio flows towards emerging economies have recently trended downwards after a surge following the previous reporting period.

18. Against this background, marginal funding rate, which was gradually lowered under the simplification process since March 2016, was kept constant in October. The completion of the simplification will ensure funding via a single rate, thereby

bringing short-term market rates closer to the CBRT funding rate. Simplification is believed to contribute to the effectiveness of the transmission mechanism by providing better assessment of the monetary policy stance. Therefore, simplification of the monetary policy will be finalized within a reasonable schedule. The direction and the timing of simplification will depend on the developments regarding inflation and financial stability.

19. Despite experiencing significant external shocks in recent years, the adopted policy framework proved successful in containing the deterioration in inflation and inflation expectations. However, price stability is yet to be achieved. Ten years of experience in inflation targeting showed that combatting inflation requires joint efforts. Thus, to reduce inflation to the 5-percent target permanently, all institutions must fulfill their duties under a holistic approach by also taking structural factors into account. In this respect, actions taken by the Food Committee set an invaluable precedent. In the upcoming period, the CBRT will contribute to these efforts by undertaking extensive studies to raise awareness regarding structural issues in inflation dynamics.

20. In the upcoming period, the monetary policy stance will continue to depend on the inflation outlook. The CBRT will maintain its cautious monetary policy stance by taking into account the developments regarding inflation expectations, the pricing behavior and other factors affecting inflation.

21. Developments in 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.

22. In recent years, sustaining fiscal discipline has become one of the major factors in reducing the sensitivity of the Turkish economy against external shocks. 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 the interest rates of long-term government securities at low levels.