

PRESS RELEASE

26 April 2016

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 20 April 2016

Inflation Developments

1. In March, consumer prices edged down by 0.04 percent, and annual inflation dropped by 1.32 points to 7.46 percent. As also stated in the Summary of the March MPC Meeting, this fall in inflation stemmed from unprocessed food prices. In this period, annual inflation in core indicators recorded a slight fall, while the underlying trend continued to improve on the back of the core goods group.
2. Annual inflation in the food and non-alcoholic beverages group fell by 4.25 points to 4.58 percent. This was mainly driven by unprocessed food prices, the annual inflation of which plunged to 0.22 percent due to prices of fresh fruits and vegetables. On the processed food front, annual inflation sustained the uptrend due to the price developments in the bread-cereals group but with a diminishing pace. Meanwhile, leading indicators hint at a notable decline in unprocessed food annual inflation in April as well. On the energy front, prices rose by 0.60 percent due mainly to international oil prices, while annual inflation decreased to 1.83 percent due to the base effect.
3. Prices of services increased by 0.38 percent, and the annual services inflation receded by 0.20 point to 8.86 percent in March. Annual inflation decreased in the other services and restaurants-hotels groups, but increased in remaining subgroups. The underlying trend of services prices remained at high levels, which is attributed to high levels of inflation expectations and the pricing behavior as well as increased costs amid wage developments and cumulative exchange rate effects.
4. Annual core goods inflation edged down by 0.24 points to 10.13 percent in March. Having increased since September, the annual clothing inflation recorded a decline in this period. Owing to the decelerating cumulative exchange rate effects, core goods excluding clothing saw a further decline in annual inflation, albeit limited. In addition, the recent stable course of the Turkish lira led to an improvement in the underlying trend of core goods inflation.

5. In sum, inflation has recently recorded a notable decline. Driven mainly by the unprocessed food group, this decline is expected to continue in the short term. Despite the fall in inflation, the Committee stated that the improvement in core inflation was limited.

Factors Affecting Inflation

6. According to the TurkStat, Gross Domestic Product (GDP) rose by a quarterly 0.7 percent and a yearly 5.7 percent in the fourth quarter of 2015. Thus, the economy grew by 4.0 percent in 2015. On the production side, the industrial value-added made the greatest contribution to quarterly growth in the last quarter. Finance and insurance activities accounted for most of the services value-added over the year. Meanwhile, the noticeable agricultural value-added growth and rise in net taxes upon the increasing production of petroleum products made a significant contribution to growth throughout the year. On the expenditure side, investment spending was the main driver of final domestic demand in quarterly terms. In this period, consumer spending slowed and external demand declined. In sum, 2015 was marked as a year with faster private consumption growth than the GDP growth, recovering capital accumulation and contracted external demand.
7. Data for the first quarter of 2016 suggest that economic activity remains on the rise. Industrial production increased by 1.6 percent during January-February period relative to the previous quarter's average. Given the external trade outlook and survey data for March, industrial production is expected to expand further in the first quarter.
8. Data on spending side point to a moderate domestic demand in the first quarter. Among indicators of private consumption, the production and imports of consumer goods rose in the January-February period. Likewise, sales of automobiles, home appliances, and homes were up. On the investment side, the production of capital goods dropped whereas their imports increased. Yet, the production of nonmetallic minerals expanded while their imports receded. Sales of commercial vehicles were also down in the first quarter. Accordingly, it is assessed that private consumer spending was more robust than investments, and private consumption was the main driver of domestic demand in the first quarter.
9. Favorable developments in the terms of trade accompanied by the moderate course of consumer loans support the recovery in the current account balance. The growing EU demand and Turkey's high market-shifting flexibility limit downside risks caused by geopolitical developments. Thus, amid continued EU demand growth, low commodity prices, and ongoing macroprudential policies, the current account balance is expected to improve further.
10. Seasonally-adjusted unemployment rates were down on a month-on-month basis in January 2016, due to the increase in nonfarm employment and decline in labor supply. Across sub-sectors, services provided the largest contribution to nonfarm

employment growth, while construction employment also increased. Industrial employment, on the other hand, was slightly down in January for the second month in a row. In view of production and survey indicators, employment is expected to remain on a modest track in the short term.

11. To sum up, current indicators suggest that the economy continues to grow at a steady and moderate pace. In the upcoming period, domestic demand is likely to be supported by the income channel through wage increases and low oil prices. Although geopolitical developments pose a downside risk, the growing EU demand continues to stimulate exports.

Monetary Policy and Risks

12. The Committee discussed the medium-term projections to be published in the April Inflation Report. In the first quarter of 2016, inflation remained below the projections of the January Inflation Report mainly due to unprocessed food prices. However, inflation excluding unprocessed food and tobacco was close to the January forecast in this period. Considering the assumptions underlying the forecasts and the course of exogenous variables, inflation forecasts for the upcoming period were left unchanged from the previous report. After the January Inflation Report, the Turkish lira remained stable while oil prices inched up and import prices edged down slightly. Accordingly, the impact of TL import prices was not significant enough to lead to any change in the inflation forecasts. Despite the recently slumping unprocessed food inflation, assumptions for food inflation are preserved given high volatility in food prices.
13. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. After slowing down in the fourth quarter of 2015, particularly for consumer loans, the growth trend of loans picked up in the first quarter of 2016. Risk weight and minimum wage arrangements and improving financial conditions are likely to boost loan growth in the upcoming period via loan supply and household income channels. Thus, annual loan growth rates are expected to remain at reasonable levels. With respect to the composition of loans, commercial loans continue to grow faster than consumer loans. This composition not only limits medium-term inflationary pressures but also supports the improvement in the current account balance.
14. Recent data and the leading indicators show that economic activity displays a moderate and stable course of growth. In the forthcoming period, domestic demand is likely to contribute more strongly to growth while the growing EU demand will further stimulate exports in spite of geopolitical risks. Strengthened investor and consumer confidence driven by reduced domestic uncertainties, recently improved financial conditions, robust post-global-crisis employment performance, and the early 2016 minimum wage hike are all expected to support domestic demand. On the foreign demand front, geopolitical developments and weaker global growth continue to pose downside risks, with those to exports of services recently being on the rise.

Nevertheless, the economic recovery in Europe and the market-shifting flexibility of our exports cap these downside risks. In fact, the rising EU demand has had a favorable effect on exports recently, which is conducive for both economic growth and rebalancing prospects. Moreover, improvements in the terms of trade mainly led by the cumulative fall in commodity prices, coupled with the modest course of consumer loans, support the improvement in the current account balance. Against this background, the monetary policy stance is based on an outlook, where economic activity will remain on a moderate growth path while the current account deficit will narrow further, albeit at a slower pace.

15. The Committee assesses that the effective use of the policy tools announced in the road map of August 2015 bolsters the resilience of the economy against global shocks. The introduction of these new instruments helped to curb the excessive volatility in both exchange rates and credits. In fact, the relative volatility of the Turkish lira has decreased notably since September compared to other emerging market currencies. This process is supported by the gradually falling demand for foreign exchange amid the improving current account balance and lower energy prices. Also, foreign currency liquidity instruments are used to stabilize the value of the Turkish lira. All these developments alleviate the need for a wide interest rate corridor.
16. Other factors that have recently reduced the need for a wide interest rate corridor are the continued decline in global volatility and the improving global financial conditions. Mounting prospects of a slow global economic recovery and the sustained monetary easing by advanced economy central banks have recently fostered the expectations of a prolonged period of low interest rates across advanced economies. Accordingly, capital flows into emerging economies increased while risk premiums and market interest rates fell significantly.
17. In sum, the recent lasting decline in global volatility and the effective use of the policy instruments laid out in the road map announced in August 2015 have reduced the need for a wide interest rate corridor. Thus, the Committee decided to take a measured step towards simplification by lowering the marginal funding rate.
18. On the other hand, the improvement in the underlying core inflation trend remains limited, necessitating the maintenance of the tight liquidity policy stance. Although recent developments regarding imported input costs have eased the upside risks to the inflation outlook, the improvement in core inflation is still limited. The lagged effects of cumulative exchange rate movements, high levels of inflation expectations and wage developments restrain the improvement in the underlying trend of inflation. Food inflation has recently seen a marked decline on the back of unprocessed food prices. The falling food inflation led to a decrease in consumer inflation as well, which is expected to continue in the short run. Yet, given the high volatility in unprocessed food prices, it is important to remain cautious about the inflation outlook. Hence, the Committee stated that the current tight liquidity stance

should be maintained in order to ensure that the recently observed disinflation becomes permanent.

19. In the upcoming period, 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. Moreover, global and domestic volatilities will be monitored closely and necessary measures will be taken for the foreign exchange and Turkish lira markets. In sum, the policy stance will remain tight against the inflation outlook, stabilizing for the FX liquidity and supportive of the financial stability.
20. Notwithstanding the significant external shocks in recent years, the current policy framework limited the worsening in inflation and inflation expectations. However, price stability is yet to be achieved. Ten years of experience with inflation targeting has shown that the fight against inflation requires collaboration from all relevant parties. Therefore, bringing inflation permanently down to the 5-percent target requires all institutions to continue resolutely with the efforts made in recent years.
21. 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.
22. Sustained fiscal discipline has become a fundamental element in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current environment of highly uncertain global markets, the value added from maintaining and further advancing these achievements is significant. 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.