

## PRESS RELEASE

26 July 2016

### SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 19 July 2016

#### *Inflation Developments*

1. In June, consumer prices increased by 0.47 percent, and annual inflation went up by 1.06 points to 7.64 percent. In this period, food inflation posted a notable rise due to the correction in unprocessed food prices and the base effect. Annual inflation in core indicators registered a decline, while the underlying trends remained virtually unchanged.
2. As projected in the Summary of the Monetary Policy Committee Meeting in the previous month, annual inflation in food and non-alcoholic beverages climbed to 6.63 percent in June due to unprocessed food prices. The prices of fresh fruits and vegetables in unprocessed food category increased notably. Hence, annual inflation in unprocessed food prices increased by around 9 points to 4.62 percent given the low base effect. On the other hand, processed food inflation posted the lowest monthly rate of increase over the last 3 years and annual inflation in this category declined to 8.38 percent. Preliminary indicators in July point out that annual food inflation may continue to rise due to unprocessed food prices. On the energy front, prices increased by 0.50 percent in line with the international oil prices, and annual inflation hit 2.33 percent.
3. Prices of services increased by 0.42 percent, and the annual services inflation decreased by 0.5 points to 8.25 percent in June. Prices of restaurants and hotels, which have been decelerating in the last couple of months, continued to slow down in June amid prices of accommodation services. Waning cumulative effects of the Turkish lira depreciation and the favorable course of other services supported the slowdown in the services inflation. Accordingly, the underlying trend of services inflation recorded an improvement in June. On the other hand, rents continued with the high-rated increases of the previous two months and recorded an annual inflation of 8.83 percent.
4. Annual core goods inflation increased by 0.31 points to 9.13 percent in June. Annual inflation posted a rise in durable goods, but remained flat in other subcategories.

Prices of durable goods displayed an unfavorable outlook mainly due to the depreciation of the Turkish lira in May. Prices in the automotive sector, which enjoys relatively robust sales in the domestic market, displayed an upsurge in June. Meanwhile, the labor-intensive furniture sector continued to see price increases, albeit at a decelerating pace. Accordingly, the underlying core goods inflation increased slightly. Amid the decelerating cumulative exchange rate effects, annual core goods inflation is expected to slow down in the remainder of the year.

5. In sum, consumer inflation increased in June mainly owing to the unprocessed food prices. Core inflation indicators continued to decline, albeit at a limited pace. The price hikes to tobacco products in July will pose upward pressure on consumer inflation. The Committee highlighted that inflation may register an upsurge in the short term on account of the developments in unprocessed food and tobacco prices. Meanwhile, core inflation is expected to sustain its gradual downtrend.

### ***Factors Affecting Inflation***

6. Data for the second quarter of 2016 indicate an ongoing yet slowing uptrend in economic activity. Adjusted for seasonal and calendar effects, the industrial production index increased by 1.6 percent month-on-month in May; however, the sluggish course in April caused production to see a quarterly fall of 0.4 percent during April-May period. Current indicators for June suggest that industrial production may follow a more moderate path compared to May. Survey indicators on output and orders were down in June, while automobile manufacturing recorded a small drop.
7. Data on the spending side point to a modest course in final domestic demand. The production of consumer goods remained horizontal during April-May period, whereas the imports thereof declined. A similar pattern was observed in the production and imports of investment goods. Meanwhile, sales of automobiles and commercial vehicles remained on the rise in the second quarter. Firms' investment demand was relatively weak in the second quarter. In the April-May period, the non-gold export quantity index was up only slightly from the first quarter, while the non-gold import quantity index posted a fall.
8. Favorable developments in the terms of trade accompanied by the moderate course of consumer loans support the recovery in the current account balance. Despite heightened geopolitical risks, exports to the European Union countries continue to grow at an accelerated pace in the recent period. In this regard, Turkey's high market-shifting flexibility supports exports. Yet, the possible spillovers of falling tourism revenues on the current account deficit may be felt more markedly by the summer months. Meanwhile, commodity prices are also expected to become gradually less supportive of the current account deficit in coming months.
9. Seasonally adjusted unemployment rates remained unchanged month-on-month in April. In this period, non-farm employment continued to grow, while the rising participation rate restricted the decline in unemployment rates. The upsurge in

construction employment was interrupted, while industrial employment recovered back to 2015 levels after falling in the first few months. Services employment continues to expand, albeit at a slower pace than in March. The employment growth in services continues to be driven by public administration and community services. In the light of leading indicators, employment is expected to remain on a modest track in the short term. Yet, the data by the Social Security Institution indicate that the stagnant tourism sector has started to have spillovers on employment.

10. To sum up, current indicators suggest that the economy continues to grow at a moderate and steady pace. The income channel supports domestic demand through wage increases. Although geopolitical developments pose persisting downside risks, the growing demand from European Union countries continues to have favorable effects on exports, and thus production. However, the ongoing slump in the tourism sector poses a downside risk to economic activity and the current account balance.

### ***Monetary Policy and Risks***

11. The Committee evaluated the medium-term projections to be published in the July Inflation Report. In the second quarter of the year, inflation increased in line with the projections of the April Inflation Report mainly due to unprocessed food and energy prices, but went down across core items. Even though inflation is projected to rise in the short term, core inflation is expected to settle on a milder track across the year. The recent hikes in unprocessed food prices and the tobacco price adjustments will cause an upsurge in July inflation. Yet, food prices may see a downward correction in the upcoming periods. Owing to the measures taken by the Food and Agricultural Product Markets Monitoring Committee (Food Committee) accompanied by the seasonal decline in food demand caused by the tourism sector, the year-end food price inflation is expected to prove lower compared to the previous reporting period. In addition, owing to the expected deceleration in economic activity in the short term, core inflation is anticipated to exhibit a milder course compared to the previous reporting period across the year. Meanwhile, the minimum wage hike is estimated to have a limited effect on core inflation on the back of state support. Given the forecast assumptions and external conditions, inflation forecasts for the upcoming period were left unchanged from the previous Inflation Report.
12. Financial conditions continue to be tight despite the recent rise in the global risk appetite, which slightly eased conditions. Financial conditions are likely to remain tight in the short term owing to domestic developments and weaker capital flows. Accordingly, loan growth rates are not expected to recover notably. The moderate course of loans is driven not only by demand but also by the supply-side factors. Recent surveys show that loan standards did not display any easing. Domestic developments have recently led to fluctuations in markets. Liquidity measures taken by the Committee have partially limited the volatility in markets. It is projected that the effects of the fluctuations in markets will prove temporary and Turkey will sustain its resilience through its sound economic fundamentals. On the other hand, to

balance the short-term effects of the tightness in financial conditions, the Committee may make downside adjustments to required reserves, if deemed necessary.

13. Economic activity maintains a moderate and stable course of growth. Consumption spending fuels the domestic demand, while investments remain relatively sluggish. 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 support external demand as of the last quarter. Accordingly, exports are expected to provide further support to growth in the upcoming period. Meanwhile, the steady increase in employment and wage developments boost domestic demand through the income channel. In this respect, economic activity is expected to grow moderately across the year.
14. Recent terrorist attacks and domestic developments pose a downside risk to economic activity especially through the tourism sector. Thus, the economy may witness a slowdown in the second and third quarters in which tourism revenues register high share within economic activity. In fact, leading indicators of the second quarter point to a quarter-on-quarter deceleration, which may also continue through the third quarter. On the other hand, the economy is expected to maintain a steady course of growth amid structural arrangements and investment incentives. Against this background, risks to economic activity are likely to be balanced in the medium term.
15. The current account deficit may widen slightly in the short term even though external balances continue to recover. The current account balance is being positively affected by the lagged effects of the decline in energy prices. Moreover, the moderate course of loans and the increasing share of commercial loans in loan composition also support the improvement in the current account balance. However, the fact that the current economic growth is fueled by the domestic demand and that the tourism sector is experiencing a slowdown signals for a possible deceleration in the recovery of the current account balance in the upcoming period. Yet, the current account deficit is estimated to hover at reasonable and predictable levels across the year.
16. Inflation forecasts accommodate both upside and downside risks. Recent exchange rate developments pose an upside risk to inflation through the cost channel. Moreover, the possible adjustments to administered prices and taxes to compensate for the effect of the recent rise in budget expenditures on fiscal balances may push inflation upwards towards the end of the year. On the other hand, latest domestic developments constitute downside risks to demand and inflation through the confidence channel and the tourism sector. The Committee will closely monitor the developments affecting inflation and take necessary policy measures to achieve price stability.
17. Despite experiencing significant external shocks in recent years, the adopted policy framework was successful in containing the deterioration in inflation and inflation

expectations. However, at this point, price stability is yet to be achieved. Ten years of experience with the inflation targeting regime showed that combatting inflation requires joint efforts. Thus, in order to reduce inflation to the 5-percent target permanently, all institutions must fulfill their duties by 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 examine structural issues in inflation dynamics.

18. Global financial markets and capital flows remain highly volatile. Despite the recent slight rise in the risk appetite, persisting concerns over global growth and uncertainties in global monetary policies feed into volatility. 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 enhanced the resilience of the economy against external shocks to a certain extent. However, adverse domestic developments may cause fluctuations in markets if accompanied by global volatilities and this may place extra pressure on financial conditions. The Committee will closely monitor the developments in both global and domestic markets and take necessary stabilizing measures by utilizing its large variety of tools.
19. The recent monetary policy decisions of the Committee should be evaluated under the scope of the simplification process. The ultimate aim of the simplification is to achieve a narrow and symmetrical corridor and provide funding via a single rate. The 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.
20. 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.
21. 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.