TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 23 February 2016

Inflation Developments

1. In January, consumer prices edged up by 1.82 percent, and annual inflation rose by 0.77 points to 9.58 percent. This rise in inflation is attributed to the products with administered prices and unprocessed food prices. The total effect of adjustments in certain products with administered prices in early January amounted to 0.7 points, as projected. Core goods inflation continued to rise, and services inflation maintained its high level. Accordingly, annual inflation of core indicators recorded an increase, while their underlying trend improved slightly.

2. Annual inflation in food and non-alcoholic beverages rose by 0.82 points to 11.69 percent. This was mainly driven by unprocessed food prices that increased due to the prices of fresh fruits and vegetables. Annual inflation reached 20.09 percent in this sub-group, while that in unprocessed food hit 15.33 percent. On the processed food front, annual inflation increased to 8.41 percent amid the price developments in bread-cereals group in the last two months. Leading indicators for February suggest a downtrend in food inflation.

3. On the energy front, prices rose by 0.81 percent due to electricity prices, and annual inflation climbed to 4.61 percent. Annual energy inflation is envisaged to fall due to developments in oil prices coupled with the base effect in February.

4. Prices of services increased by 1.34 percent, and annual services inflation increased to 9.16 percent in January. Prices of services recorded the fastest monthly increase of the last ten years, and high increases spread across sub-groups. The gradually slowing price increases in the restaurants-hotels group amid the moderate course of meat prices in the last quarter of 2015 re-accelerated in January. In addition to wage developments and the high course of food inflation, accumulated exchange-rate pass through effects delay the fall in services inflation.

5. Annual core goods inflation edged down by 0.12 points to 10.10 percent in January. Annual inflation decreased in durable goods, but maintained its uptrend in other sub-groups. Effects of the exchange rate continued with a dwindling pace in prices of core goods excluding clothing and durable goods, while the decline in clothing prices remained below seasonal averages. On the other hand, seasonally-adjusted indicators suggest an improvement in the underlying trend of core goods inflation in January.

6. In sum, energy prices continue to affect inflation favorably, while other cost factors limit the improvement in the core inflation trend.

Factors Affecting Inflation

7. Industrial production recorded an increase in December compared to previous month. Quarterly production in the fourth quarter materialized above the third quarter. The headline PMI and the PMI production indices fell in January, despite staying above neutral levels. Business Tendency Survey data suggest that domestic orders registered an increase from the previous quarter’s average, while export orders were relatively weaker. Given these indicators as well as data on exports and imports, the pace of industrial production growth is expected to decelerate somewhat in January.

8. Data on the expenditure side suggest a milder course of private demand growth in the final quarter of 2015 relative to the third quarter. In this period, the production and imports of consumer goods were down from the previous quarter’s average. Among indicators of investment, the production of capital goods posted a modest fourth-quarter growth, whereas the imports receded. The production of non-metallic minerals and sales of heavy commercial vehicles, which are indicators for construction investments, registered an increase. Among indicators for the first quarter of 2016, auto sales remained subdued in January, while home appliance sales were up. Consumer confidence indices declined in January and February yet remained above the October level. Meanwhile, data on the investment tendency hint at a moderate growth. Against this background, private demand is expected to rise modestly in the first quarter of 2016.

9. 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, the growing EU demand continues to support exports. The recovery in Europe, one of Turkey’s major export markets, continued into January. Additionally, Turkey’s high market-shifting flexibility also supports exports. Thus, amid a continued EU demand growth, low commodity prices and ongoing macroprudential policies, the current account balance is likely to improve further in 2016, which, however, might be restrained by the likely fall in tourism revenues due to geopolitical developments.

10. Unemployment rates were down month-on-month in November 2015. In this period, employment grew at a faster pace than labor force in nonfarm sectors. Across sub-sectors, the services provided the largest contribution to nonfarm employment growth. Industrial employment decreased marginally, whereas construction employment picked up. Industrial production and survey indicators signal no additional rebound for industrial employment over the upcoming period. The course of nonmetallic mineral production indicates a moderate growth in construction employment. Employment data for sub-sectors of services remain volatile. Leading indicators for the labor market suggest that unemployment rates will remain flat over the coming months.

11. In conclusion, recent indicators suggest that the economy continues to grow at a 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 tensions pose a downside risk, demand from the European Union economies continues to support exports at an increasing pace.

Monetary Policy and Risks

12. Although energy price developments continue to affect inflation favorably, other cost factors limit the improvement in the core inflation trend. Meanwhile, food prices remain volatile largely due to unprocessed food prices. Leading indicators point to a likely downward correction in unprocessed food prices in the short term. Moreover, the waning of the lagged pass-through effects of cumulative exchange rate movements might contribute to disinflation in coming months. Against this backdrop, the Committee expects the disinflation to resume by February. Yet, developments in both wages and inflation expectations pose an upside risk to the core inflation outlook. Thus, core inflation indicators are likely to remain elevated for some time. The adverse impact of the above-target inflation on inflation expectations and the acceleration in wage increases necessitates a close monitoring of the overall pricing behavior. Therefore, the current tight monetary stance should be maintained in order for the impending disinflation to be permanent. Against this backdrop, considering the impact of wage developments and the uncertainties in global markets on inflation expectations and the pricing behavior, and taking into account the volatility in energy and unprocessed food prices, the Committee stated that the tight liquidity stance will be maintained as long as deemed necessary. Future monetary policy decisions 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.

13. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. Recent data point to no major change in the underlying trend of loans. Adjustments in risk weights and minimum wages are considered to support loan growth through the loan supply and household income channels. Yet, the ongoing financial tightening is likely to keep annual loan

growth rates at reasonable levels. With respect to the composition of loans, commercial loans continue to grow faster than consumer loans. Such a composition not only limits medium-term inflationary pressures but also supports the improvement in the current account balance.

14. Leading data indicate that domestic demand has slowed somewhat as of mid-2015 but continues to contribute to growth modestly. The financial tightening due to persisting global volatility dampens domestic demand growth, whereas energy prices and wage developments bolster domestic demand through the income channel. On the foreign demand front, geopolitical developments pose a downside risk, yet the European economic recovery and the market-shifting flexibility of Turkish exports offset this risk. In fact, the favorable effect of the growing EU demand on exports has become more significant recently. 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. Overall, economic activity is expected to remain on a moderate growth path while the current account deficit is expected to narrow further in the upcoming period.

15. The Committee assesses that the effective use of the policy tools announced in the road map of August 2015 strengthen the resilience of the economy against global shocks. This process is supported by a gradual reduction in demand for foreign exchange due to improved current account balance and lower energy prices. Meanwhile, foreign currency liquidity instruments are used to stabilize the value of the Turkish lira. In this context, foreign currency liquidity is provided through flexible foreign exchange sales auctions at amounts deemed necessary.

16. Nevertheless, uncertainties surrounding global monetary policies and concerns over global growth cause global markets to remain volatile. Emerging-market portfolio inflows and risk premiums follow a fluctuating pattern, while exchange rate volatilities remain elevated. In the forthcoming period, both global and domestic volatilities will be monitored closely and required measures in foreign exchange and Turkish lira markets will continue to be taken. In the case of sustained volatility, additional measures might be taken to support the Turkish lira by adjusting the funding conditions for the use of foreign currency denominated collateral, while maintaining the tight monetary policy stance.

17. In this respect, the Committee stated that the policy stance will remain tight against the inflation outlook, stabilizing for the FX liquidity and supportive of the financial stability.

18. The Committee stated that the wide interest rate corridor has contributed markedly to containing exchange rate volatility in times of heightened global volatility. The need for such an instrument would be reduced, should the decline in global volatility prove persistent. Another factor that may reduce the need for a wide interest rate

corridor is the effective use of the policy instruments laid out in the road map published in August. Excessive fluctuations in both exchange rates and loans have waned owing to the launch and effective use of these instruments. The Committee still maintains the view that the monetary policy may be implemented within a narrower and more standard interest rate corridor, should global volatilities post a permanent decline or the policy tools of the August road map permanently contain the effects of the global volatility on the Turkish economy.

19. 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.

20. 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.