

PRESS RELEASE

31 May 2016

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 24 May 2016

Inflation Developments

1. In April, consumer prices rose by 0.78 percent, and annual inflation dropped by 0.89 points to 6.57 percent. Consumer inflation declined further on the back of unprocessed food prices. In this period, annual inflation in core indicators remained high, while their underlying trend continued to improve.
2. Annual inflation in the food and non-alcoholic beverages group fell by 3.20 points to 1.38 percent. The deceleration in food inflation was mainly driven by unprocessed food prices, the annual inflation of which plunged to -5.94 percent. In this group, prices of fresh fruits and vegetables remained below the previous year's levels due to increased supply of products, whereas red meat prices exhibit a mild outlook amid the measures in effect. On the other hand, processed food inflation sustained its high course also due to prices in the bread-cereals group. On the energy front, prices rose by 0.34 percent in line with international oil prices, while annual inflation sustained the mild outlook with 1.74 percent.
3. Prices of services increased by 0.64 percent, and the annual services inflation edged down by 0.10 point to 8.76 percent in April. Being the culprit of high figures in services inflation, the restaurants-hotels and other services groups lost pace in the last couple of months. The mild course in food prices reflected favorably on prices in the restaurants-hotels group, and the attenuated cumulative depreciation in the Turkish lira underpins the slowdown in inflation in other services. On the other hand, inflation in transport services continued with an uptrend and rent inflation rose to 8.39 percent. All in all, despite some deceleration, the underlying trend of services prices remained high.
4. Annual core goods inflation remained flat with 10.11 percent in April. Annual inflation recorded an increase in the clothing group, but edged down in others. Prices of durable goods registered a modest monthly increase by 0.43 percent, yet the uptrend in subgroups like furniture and white goods proved notable. The underlying trend of core goods weakened further, and when clothing is excluded, the

improvement is more remarkable. Amid the decelerating cumulative exchange rate effects, annual core goods inflation is projected to slow in the second half of the year.

5. In sum, inflation has recently recorded a notable decline driven mainly by the unprocessed food prices. Despite the fall in inflation, the Committee stated that the improvement in the underlying core inflation trend remains limited.

Factors Affecting Inflation

6. Data for the first quarter of 2016 suggest that economic activity remains on the rise. Up by 1.5 percent from the previous quarter's average, industrial production recorded the largest increase since the first quarter of 2014. Production of basic pharmaceuticals made the greatest contribution to quarterly growth, while main industries such as food, clothing and textiles also contributed to growth, which is a favorable development. In addition, the steady increase in the exports to the EU is another factor supporting industrial production growth.
7. Data on spending side point to a rising domestic demand for the first quarter. Among indicators of private consumption, the production and imports of consumer goods grew robustly. Likewise, sales of automobiles, home appliances and homes were up in the first quarter. On the investment side, the production of capital goods dropped whereas their imports increased. The production of capital goods declined due to vehicle manufacturing, yet vehicles excluded, it posted a rise. Moreover, both the warmer-than-normal weather in winter months and the upsurge in the production and imports of nonmetallic minerals suggest some increase in construction activities for the first quarter. Against this background, 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.
8. 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 continues to support exports. High market-shifting flexibility of exports limits 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. Yet, the falling number of foreign visitors weighs on revenues from services, posing a downside risk to the current account deficit.
9. Seasonally-adjusted unemployment rates were down month-on-month in February 2016, due to the weakening labor supply and the moderate gain in nonfarm employment. Across sub-sectors, services provided the largest contribution to nonfarm employment growth, while construction employment continued to expand. Meanwhile, industrial employment continued to drop slightly in February. In view of production and survey indicators, employment is expected to remain on a modest track in the short term. This labor market outlook is likely to spur growth in 2016.

10. In sum, current indicators suggest that the economy continues to grow at a moderate and steady pace. In the upcoming period, the income channel is likely to push domestic demand higher through wage increases and a food price-driven decline in headline inflation. Although geopolitical developments continue to pose downside risks, the growing EU demand continues to support exports, and thus production.

Monetary Policy and Risks

11. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. Risk weight and minimum wage arrangements are expected to boost loan growth further in the upcoming period via loan supply and household income channels. Thus, annual loan growth rates are likely 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.

12. Economic activity remains on a moderate and steady growth track. In the first quarter, industrial production recorded a robust quarter-on-quarter increase while external demand supported growth. In the forthcoming period, domestic demand is expected to provide further support to growth while the rising EU demand will continue to promote exports. Employment remained on a moderate upward path in the first quarter. Given wage developments, employment growth is likely to support domestic demand further through the income channel. On the external demand side, geopolitical tensions and the weakening global growth continued to pose risks, and risks to services exports became prevalent. However, the European economic recovery and the market-shifting flexibility of exports alleviate the downside risks to external balance. Moreover, the favorable impact of the cumulative fall in commodity prices on the terms of trade and the moderate course of consumer loans contribute to the improvement in the current account balance.

13. Recently, the global volatility has increased to some extent amid ongoing concerns over global growth and continued uncertainty about global monetary policies. Accordingly, emerging-market portfolio flows slowed slightly while risk premiums and exchange rate volatilities recorded increases. The Committee assesses that the tight monetary policy stance, the cautious macroprudential policies and the effective use of the policy instruments laid out in the road map published in August 2015 enhance the resilience of the economy against shocks. These policy measures have tamed the heightened volatility in both exchange rates and loans. In fact, the Turkish lira has followed a relatively less volatile path than other emerging market currencies since September 2015. Against this backdrop, the Committee decided to take a measured step towards simplification by lowering the marginal funding rate. Moreover, within the context of the road map, related departments made presentations about the arrangements that would increase the predictability of liquidity policy and make liquidity management of banks more efficient.

14. On the other hand, the improvement in the underlying core inflation trend remains limited, necessitating the maintenance of the tight liquidity policy stance. Although low imported-input costs have eased the upside risks to the inflation outlook, the improvement in core inflation is still limited. The weakening yet ongoing 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. Yet, given the elevated core inflation, it is important to remain cautious about the inflation outlook. To this end, the Committee stated that the current tight liquidity stance should be maintained in order to ensure that the recently observed disinflation becomes permanent.
15. In the upcoming period, the 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 financial stability.
16. 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.
17. 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.