

Press Release

27 December 2016

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 20 December 2016

Inflation Developments

1. In November, consumer prices went up by 0.52 percent, while annual consumer inflation fell by 0.16 points to 7.0 percent. As stated in the Summary of the Monetary Policy Committee Meeting of November, annual food inflation receded considerably, while energy inflation increased due to the depreciation in the Turkish lira. On the other hand, the effect of recent exchange rate movements on core inflation indicators remained relatively limited due to the slowdown in aggregate demand. Thus, the underlying trends of core indicators displayed a practically flat course.
2. Annual inflation in food and non-alcoholic beverages fell by 1.65 points to 3.55 percent, which was led by the falling unprocessed food prices due to the decline in the prices of vegetables. Annual processed food inflation remained on the decline. Leading indicators regarding December suggest an uptick in annual food inflation on account of the unprocessed food inflation. Energy prices increased by 1.05 points in November and the depreciation in the Turkish lira resulted in overall price hikes in the sector. Thus, annual energy inflation rose by 1.44 points to 6.15 percent. This rise is expected to continue in December due to the uptrend in the exchange rate coupled with oil prices. In addition to food and energy groups, recent tax adjustments introduced to some items, chiefly tobacco products, is envisaged to put a noticeable upside pressure on December inflation.
3. Prices of services recorded an uptick by 0.29 percent, and annual services inflation crept up by 0.14 points to 7.94 percent in November. Annual inflation decreased in transport and rent, but increased in other sub-groups in this period. Consequences of the slowdown in domestic demand and the tourism sector were evident in the prices of services, while some groups reflected the effect of depreciation of the

Turkish lira as well. In this respect, the underlying trend of services inflation registered a slight increase.

4. Annual core goods inflation inched down by 0.22 points to 5.92 percent in November. Inflation plummeted in the clothing group, but increased in durable goods. Recent exchange rate developments had a limited effect on durable goods in November. This month was marked by a notable depreciation in the Turkish lira, while aggregate demand conditions confined the deterioration in the underlying trend of core goods inflation.
5. In sum, the effect of the recent rise in exchange rate and oil prices on inflation remained relatively limited due to aggregate demand conditions.

Factors Affecting Inflation

6. The GDP narrowed by 1.8 percent year-on-year in the third quarter and grew by 2.2 percent through the first nine months of 2016. The Committee assessed that the underlying growth of economic activity is not as slow as third-quarter GDP data suggest. In fact, mid-July incidents and the loss of working days caused by extended religious holidays had far more implications than normal calendar effects. Adjusted for such effects, the economy is estimated to register a year-on-year expansion rather than a contraction in the third quarter.
7. In the third quarter, value-added was up in construction but down in agriculture, industry and services on a yearly basis. On the spending front, public consumption provided further support to growth. Meanwhile, construction investments contributed to annual growth positively whereas machinery and equipment investments and private spending declined. Domestic demand continued to prop up growth, albeit to a lesser extent, while the effects of the tourism slump became more pronounced and net exports provided an increased negative contribution to growth.
8. Recent data indicate that economic activity rebounded somewhat in the fourth quarter after the third-quarter deceleration. With working day losses led by extended religious holidays counterbalanced and the underlying trend on a modest upward track, industrial output increased in October. Data on the production and exports of electricity and vehicles point to further growth in industrial output for November. Thus, industrial production is likely to post a quarterly gain in the fourth quarter thanks to the base effect from unworked days. However, apart from the

very much technical recovery driven by working day effects, the economy recovery seems to be a moderate one yet to spread across all sectors.

9. Economic activity is expected to recover further amid accommodative incentives and measures. This estimation is supported by the data on mortgage and auto markets. Thanks to more accommodative monetary conditions and other newly-adopted measures, consumer loans have picked up in recent months, bolstering the prospects for a gradual improvement. Moreover, the public sector is expected to provide further investment support to growth in the coming months.
10. The growing EU demand continues to stimulate total exports, the auto industry in particular. Turkey's flexibility in market diversification continues to cushion exports against the negative effects of geopolitical tensions on external demand. Furthermore, the newly-restored relations with Russia translated into a boost for exports. The gloomy tourism industry continues to have a negative impact on the current account balance, which, however, is alleviated by the lagged pass-through of terms-of-trade developments and the moderate course of loans. However, commodity prices are expected to become gradually less accommodative for the current account deficit in the upcoming period.
11. The labor market decline that began in May paused in September amid rising nonfarm employment. The growth in nonfarm employment was mostly driven by the increased construction employment. Meanwhile, services and industrial employment picked up only modestly. Leading indicators such as new job vacancies and unemployment insurance claims suggest that employment remains subdued and unemployment rates will remain at high levels.
12. In sum, economic activity edged up in the fourth quarter and is expected to record a moderate growth in 2016. However, the potential impact of recent global and geopolitical developments on financial conditions and the lack of any signs of a rosy tourism outlook remain a downside risk to the pace of economic recovery.

Monetary Policy and Risks

13. Consumer loans continue to improve amid falling interest rates and macroprudential measures. Nevertheless, due to global and geopolitical spillovers into domestic financial markets, commercial loans remain weak. Measures taken by

the Economic Coordination Committee to uplift the real sector are expected to help commercial loans increase in the upcoming period.

14. The ongoing uncertainty over global monetary policies and enhanced Fed rate hike prospects lead to financial market volatility and portfolio outflows in emerging economies. To counteract their negative spillovers into exchange rates and lending standards, the CBRT maintains a stabilizing stance for FX liquidity and a supportive macroprudential policy stance.
15. Domestic demand is expected to start recovering by the fourth quarter amid accommodative incentives and measures. Yet, global market turmoil and geopolitical risks keep a firm lid on the pace of economic recovery. Thus, economic activity is likely to grow moderately in the upcoming period. The CBRT will continue to monitor the developments in economic activity and their implications for price stability and financial stability. The Committee stated that adopting structural reforms might boost the economy's growth potential to a large extent.
16. Exchange rate movements and rising oil prices fueled by the recently heightened global uncertainty pose an upside risk to the inflation outlook. Recent price movements and current weather forecasts add to the upside risks to food prices for the coming months, which, however, are curbed by aggregate demand. The Committee agreed that future developments should be closely monitored to determine the net effects of these factors on the inflation outlook for 2017.
17. Against this background, the Committee kept the marginal funding rate constant in December and maintains its position that the simplification should be completed within an appropriate time frame. The gains that were planned through simplification are performing to a great extent. The direction and the timing of the next step toward simplification will depend on the developments in inflation and financial stability.
18. Monetary policy decisions will depend on the inflation outlook in the upcoming period. The CBRT will maintain its cautious stance in light of future developments in inflation expectations, the pricing behavior and other factors affecting inflation.
19. 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.

20. 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 high global uncertainty, it is critical to maintain and further enhance these achievements. Any measure to provide permanent fiscal discipline and to reduce 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.