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## SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 24 March 2016

***Inflation Developments***

1. In February, consumer prices edged down by 0.02 percent, and annual inflation dropped by 0.80 points to 8.78 percent. The fall in inflation stemmed from unprocessed food and energy prices. Lagged effects of the exchange rate weakened further in this period. Annual inflation in core indicators recorded a slight increase, while the underlying trend continued to improve to a limited extent.
2. Annual inflation in the food and non-alcoholic beverages group fell by 2.86 points to 8.83 percent. This was mainly driven by unprocessed food prices, the annual inflation of which decreased to 8.89 percent due to vegetable prices. On the processed food front, annual inflation sustained the uptrend amid the price developments in the bread-cereals group and hit 8.79 percent. Meanwhile, leading indicators suggest a notable decline in food inflation in March as well.
3. On the energy front, prices fell by 0.56 percent due mainly to fuel prices, and annual inflation decreased to 2.85 percent. Annual energy inflation is envisaged to fall further due to the base effect in March.
4. Prices of services increased by 0.59 percent, and annual services inflation receded to 9.06 percent in February. Annual inflation decreased in the communication and restaurants-hotels groups, but increased in other subgroups. Annual inflation in the rent group hit the highest level of the last six years. The high course of inflation expectations and wage developments as well as lagged exchange rate pass-through effects delay the fall in services inflation.
5. Annual core goods inflation edged up by 0.27 points to 10.37 percent in February. Annual inflation registered an increase across all subgroups. Annual inflation of durable consumption goods maintained high levels with 12 percent, and that of the clothing group hit 9.80 percent. Upward trend in core goods excluding clothing and durable goods continued. On the other hand, seasonally-adjusted indicators suggest

a slowdown in the underlying trend of core goods inflation due to the dwindling effects of the cumulative depreciation in the Turkish lira.

6. In sum, food and energy prices have affected inflation favorably, while other cost factors have limited the improvement in the core inflation trend recently.

***Factors Affecting Inflation***

7. January industrial production increased by 1 percent month-on-month in seasonally adjusted terms, which was 1.3 percent above the previous quarter. Thus, the growth trend of 2015 was preserved in January. Survey indicators and external trade data suggest a similar pace of growth in February.
8. Data on the expenditure side suggest a modest course of private demand growth in the first quarter of 2016. The production of consumer goods was higher than the previous quarter's average in January. In addition, the sales of home appliances and automobiles picked up in February after a sluggish January. The uptrend across these industries is likely to continue into March. Survey-based indices for domestic orders also point to a continued moderate rise in domestic demand. Among indicators of investment, the production and imports of capital goods posted a small decline in January; yet the decline was mostly attributed to the vehicle industry and expected to be short-lived. The production of non-metallic minerals and the sales of heavy commercial vehicles, which are indicators for construction investments, registered a drop caused partly by adverse weather conditions. Meanwhile, the consumer confidence indices and the investment sentiment reveal that the contribution of the confidence channel to domestic demand is still limited. 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. The growing EU demand continues to support exports. Turkish exporters’ flexibility in shifting between markets contains the downside risks resulting from geopolitical tensions. Thus, amid an ongoing EU demand growth, low commodity prices and sustained macroprudential policies, the current account balance is likely to improve further.
10. Unemployment rates were down month-on-month in December 2015, largely due to growing nonfarm employment and lower labor force participation. Across sub-sectors, the services provided the largest contribution to nonfarm employment growth, while construction employment also increased. Industrial employment, on the other hand, edged down for the second month in a row in December. Production and survey indicators suggest that employment growth will maintain its moderate course in the short term. Accordingly, unemployment rates are expected to remain flat in the first quarter of 2016.
11. In conclusion, recent indicators reveal that the economy continues to grow steadily as of the first quarter of 2016. Although geopolitical tensions pose a downside risk,

the EU recovery affects external demand favorably. Wage increases and low oil prices support domestic demand through the income channel. Overall, economic activity remains on a moderate growth path.

***Monetary Policy and Risks***

12. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. The modest course of loans can be attributed to both supply and demand side factors. Adjustments in risk weights and minimum wages are considered to support loan growth in the forthcoming period through the loan supply and household income channels. Yet, indicators for the loan market still point to tight financial conditions, notwithstanding the recent fall in market rates and risk premiums. Therefore, loan growth rates are unlikely to post a significant recovery in the short run. 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.

13. Recent data indicate that domestic demand continues to contribute to growth modestly albeit at a lesser extent compared to previous quarters. Ongoing tightness in financial conditions weighs on loan and domestic demand growth, whereas energy prices and wage developments provide support to domestic demand through the income channel. On the foreign demand front, geopolitical developments pose a downside risk, yet the economic recovery in Europe and the flexibility of exporters in shifting between markets offset this risk, 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. On the other hand, the Committee noted that the recent developments in services exports pose downside risks on demand, employment, and the current account balance. Although this risk is not imminent at the moment, the developments should be monitored closely to have a clearer understanding of the implications for the medium-term outlook. Overall, 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.

14. The Committee assesses that the effective use of the policy tools announced in the road map of August 2015 bolster the resilience of the economy against global shocks. Excessive volatility in both credit and exchange rates has been dampened after the adoption of these new instruments. 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. Meanwhile, foreign currency liquidity instruments are used to stabilize the

value of the Turkish lira. All these developments reduce the need for a wide interest rate corridor to some degree.

15. Another factor that has recently reduced the need for a wide interest rate corridor is the global economic and financial developments. Mounting prospects that global economic recovery will be slow 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 fell significantly.

16. In sum, global volatility has recently waned to some extent and the effective use of the policy instruments laid out in the road map of August 2015 have reduced the need for a wide interest rate corridor. In this respect, the Committee decided to take a measured step towards simplification by lowering the overnight lending rate by 25 basis points.

17. However, improvement in the underlying core inflation trend remains limited, necessitating the maintenance of a tight liquidity stance. Although recent developments regarding imported input costs have eased the upside risks on the inflation outlook, the improvement in core inflation is still limited. Wage developments and the lagged pass-through effects of cumulative exchange rate movements restrain the improvement in the underlying trend of inflation. Annual inflation in food prices, which declined significantly in February, is likely to post another sharp fall in March. Yet, this will be mainly due to prices of vegetables, suggesting that food prices might remain volatile in the upcoming period. Against this background, the Committee stated that the current tight liquidity stance should be maintained in order to ensure that the recently observed disinflation process is long lasting.

18. 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. Moreover, global and domestic volatilities will be monitored closely and necessary measures will be undertaken in 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.

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 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.