

PRESS RELEASE

29 September 2016

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 22 September 2016

Inflation Developments

1. In August, consumer prices decreased by 0.29 percent, and annual consumer inflation went down by 0.74 points to 8.05 percent. As stated in the Summary of the Monetary Policy Committee Meeting of August, this fall was driven by the correction in the unprocessed food prices. Prices of tobacco products, on the other hand, manifested the dragged effect of the July correction in August. In this period, core indicators saw a decline in annual inflation, but a slight increase in underlying trends driven by core goods.
2. Annual inflation in food and non-alcoholic beverages tumbled down to 6.19 percent due mainly to the decline in the prices of fresh fruits and vegetables. Meanwhile, inflation in food items excluding fresh fruits and vegetables has exhibited a favorable course lately. Leading indicators regarding September hint at a prolonged downward correction in unprocessed food inflation. On the energy front, prices declined on account of the falling fuel prices. Annual energy inflation climbed to 2.97 percent due to the base effect. In September, lump-sum SCT applied to fuel products was raised, which is expected to have direct effect on consumer inflation by 0.3 points.
3. Prices of services increased by 0.71 percent, and the annual services inflation fell by 0.46 points to 8.09 percent in August. Annual inflation decreased in all sub-groups except rents in this period. The fall in annual inflation was driven by the favorable course of food prices in addition to the inflation in the prices of restaurant-hotel services that lost pace due to the base effect. The surge in unit labor costs in the first half of the year played a significant role in the high course of services inflation, while the slowdown in the tourism sector restricts these effects to some extent. In this respect, the underlying trend of services inflation exhibits a limited deceleration.

4. Annual core goods inflation fell by 0.15 points to 8.67 percent in August. Annual inflation crept up in durable goods, but decreased in other groups. Lagged effects of the exchange rate on annual core goods inflation display a gradual decline. However, following the July depreciation in the Turkish lira, the underlying trend in core goods exhibited a slight increase in this period.
5. In sum, the slowdown in aggregate demand contributes to the gradual fall in core inflation. With the help of falling food prices, headline inflation is expected to display a decline in the short term. However, the recent tax adjustment in fuel prices and other cost factors limit the improvement in inflation.

Factors Affecting Inflation

6. Second-quarter TurkStat data indicate that the GDP grew by an annual 3.1 percent. Adjusted for seasonal and calendar effects, growth has lost some momentum in the second quarter, up only by 0.3 percent after seeing a modest 0.7 percent increase in the first quarter. Investments remained sluggish while private and public spending provided a major boost to growth. The spillovers of the tourism slump became more pervasive in the second quarter, causing net exports to have a heightened negative impact on growth.
7. Recent data releases and indicators for the third quarter point to a deceleration in economic activity. Calendar and seasonally-adjusted industrial production dipped both monthly and annually due to the domestic turbulence of July and the extended Ramadan holiday. This plunge is in part attributed to both the loss of working days caused by this holiday extension (bridge-day effects) and the drop in effective working days following July 15. In fact, recent indicators suggest that the recovery in August and September partly compensated for July's output loss. Nevertheless, third-quarter industrial production is expected to be lower than in the second quarter.
8. The increased EU demand continues to foster exports. Despite geopolitically-driven negative effects on external demand, Turkey's flexibility in market diversification remains supportive of exports. Recent data on external trade signal that non-gold exports were up in August, offsetting the July descent. Yet, spillovers from the troubled tourism industry into net exports were more pronounced in the summer months. The tourism slump is likely to have a short-lived negative impact on the current account balance, but the lagged pass-through of terms-of-trade developments and the moderate course of consumer loans help to improve the current account balance. Meanwhile, commodity prices are expected to become gradually less accommodative for the current account deficit in the coming months.
9. In June, seasonally-adjusted unemployment rates were up month-on-month due to narrowing non-farm employment. Thus, with the deteriorating employment outlook, unemployment rates jumped for the second month in a row. The employment decline spread across all industries. Industrial and construction

employment dropped while services employment saw a weakening growth. In light of actual data and leading indicators, unemployment rates are anticipated to surge in the third quarter. Moreover, the SSI data indicate that the stagnant tourism industry continues to weigh on services employment as of June.

10. In sum, economic activity is expected to post a quarterly fall in the third quarter. However, it is envisaged that the negative impact of the downturn in tourism on growth will be more restricted and domestic demand will start to recover on the back of accommodative incentives and measures.

Monetary Policy and Risks

11. The Committee assesses that current financial conditions are tight. The rise in global risk appetite helps to ease financial conditions, but loan standards remain tight. The gradual fall in the marginal funding rate partly passed through into loan and deposit rates. Loans are likely to see a moderate recovery over the upcoming period with the support coming from accommodative macroprudential measures.
12. Recently released data and indicators regarding the third quarter display a deceleration in the economic activity. Unemployment rates which have been on the rise for the second consecutive month due to the worsening employment outlook confirm the economic slowdown. However, leading indicators imply that the significant slowdown in industrial production observed in July is not permanent. Despite the adverse effects of geopolitical developments on external demand, exports of goods to EU members remain strong. Restored relations with Russia may also support external demand gradually. Accordingly, exports of goods are expected to provide further contributions to growth in the upcoming period. Domestic demand is likely to start recovering by the fourth quarter on account of accommodative incentives and measures.
13. In terms of global economic developments, low levels of advanced economy interest rates and commodity prices continue to affect the Turkish economy favorably. Although the uncertainty over global monetary policies have somewhat heightened, emerging economies continue to attract portfolio inflows.
14. In light of these developments and considering its contribution to the effectiveness of monetary policy, the Committee decided to take a measured and prudent step towards simplification. The ultimate aim of simplification is to achieve a narrow and symmetrical corridor and provide funding via a single rate. The 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.
15. Inflation was down in August owing to improving indicators for unprocessed food and core inflation. The lagged effects of cumulative exchange rate movements on annual inflation eased further. However, the implications of the Turkish lira's July depreciation for core goods and the pressures from unit labor costs and rigidities on

services caused the underlying core inflation to remain high. In spite of gains from lower imported-input costs, the underlying inflation improved only marginally. For the upcoming period, the slowing aggregate demand may contribute to the gradual decline in core inflation while falling food prices are expected to pull inflation down in the short term. Nevertheless, adjustments in fuel taxes and other cost-related developments put upward pressure on inflation and require the maintenance of a cautious monetary policy stance.

16. 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 cautious monetary policy stance will be maintained.
17. 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.
18. 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.