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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 24 November 2016

Inflation Developments

1. In October, consumer prices went up by 1.44 percent, while annual consumer inflation fell by 0.12 points to 7.16 percent. As stated in the Summary of the Monetary Policy Committee Meeting of October, food inflation increased, yet annual inflation in core indicators declined due to the fall in core goods and services inflation. The underlying trends of core indicators slowed due to the prices of services in this period.
2. Annual inflation in food and non-alcoholic beverages rose by 1.04 points to 5.20 percent. Although annual inflation in unprocessed food increased mostly due to the prices of vegetables, seasonally-adjusted prices recorded a decline in October as in the preceding two months. Meanwhile, annual food inflation excluding fresh fruits and vegetables maintained its favorable course. Leading indicators regarding November suggest a substantial decline in annual food inflation. On the energy front, fuel prices drove annual energy inflation upwards in October to 4.71 percent, despite the reduction in natural gas prices. The rise in fuel prices is attributed to the sustained effects of the raised SCT through October as well as the depreciation in the Turkish lira and the uptrend in oil prices.
3. Prices of services inched up by 0.35 percent, and annual services inflation fell by 0.39 points to 7.80 percent in October. Annual inflation increased in rent, remained flat in the restaurant-hotel group and decreased in other sub-groups in this period. Annual rent inflation remained on the increase due to the İstanbul and hit 9.11 percent. Inflation in other services receded amid the slowdown in economic activity. In this respect, the underlying trend of services inflation slowed down.
4. Annual core goods inflation fell by 0.83 points to 6.15 percent in October. The waning cumulative effects of the exchange rate coupled with the deceleration in domestic demand drove annual inflation down in all subgroups. However, the recent depreciation in the Turkish lira confined the improvement in annual core goods inflation. The underlying trend of core goods inflation remained flat in this period.

On the other hand, the underlying trend is expected to increase in the short run due to the weak course of the Turkish lira.

5. In sum, the slowdown in aggregate demand contributes to the fall in inflation. However, the recent exchange rate movements resulting from increased global uncertainty and high volatility limit the improvement in inflation outlook.

Factors Affecting Inflation

6. Recently released data indicate a deceleration in economic activity for the third quarter. The second-quarter downturn in industrial output deepened in the third quarter. Third-quarter production was principally hit by the loss of working days caused by the extended religious holidays in July and September and the incidents of July 15. Even excluding these effects, which are to be counterbalanced in the fourth quarter, underlying production was down, albeit at a slower clip. Being more pronounced as of the third quarter, the slump in tourism revenues was a key driver of the slowing underlying output growth through its direct and indirect effects.

7. The Committee reported that economic activity edged up when adjusted for working days that sparked an output fluctuation in the second half. Recent indicators hint at a more upbeat outlook for the fourth quarter. Production picked up slightly across credit-sensitive sectors, especially the motor industry, and related fields of activity. Given the base effect from unworked days, industrial production is expected to record a marked quarter-on-quarter rebound in the fourth quarter.

8. July's domestic tensions dampened final domestic demand through both consumer and investment spending in the third quarter. Data on production and imports suggest that the third-quarter consumption fall was more severe for durable goods. On the capital goods front, the slowdown spilled over into all industries. In fact, the production and imports of machinery and equipment and of minerals were down in the third quarter. The slide in construction employment confirms the weakening construction industry.

9. Economic activity is expected to recover by the final quarter 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 gained modestly in recent months, buoying up the improvement projected for the final quarter. Moreover, the public sector is likely to provide an increased investment support for growth in the fourth quarter. Yet, the recent Turkish lira plunge and volatile exchange rates might weigh on private demand in the upcoming period, curbing already weak investments in particular. The repercussions of exchange rate changes on the confidence over company balance sheets and the overall economic environment will be the main factors affecting the pace of growth in the coming months.

10. The growing EU demand continues to bolster exports. Turkey's flexibility in market diversification continues to cushion exports against the negative effects of

geopolitical tensions on external demand. Moreover, 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 outlook continued to deteriorate in August due to sluggish economic activity. Across nonfarm sectors, industrial employment remained on the decline, albeit at a slower rate, while construction employment was flat. Employment continued to edge up in services. Leading indicators point to an upturn in underlying unemployment. However, given the waning effects of the July turmoil, the significant rise in October's PMI employment index boding well for industrial employment gains and the subsiding repercussions of the tourism slump, the climb in unemployment might come to a standstill.

12. In short, economic activity is expected to post a quarterly fall in the third quarter. Domestic demand is envisaged to pick up in the upcoming period on the back of incentives stimulating domestic demand and recovering consumer loans. Given the base effect from unworked days of the third quarter, economic activity is likely to accelerate on a quarterly basis in the final quarter, producing a moderate growth for 2016. However, the tightening in financial conditions driven by the recent global turbulence remains a downside risk on domestic demand recovery.

Monetary Policy and Risks

13. The CBRT's liquidity measures and macroprudential policies remain accommodative for financial conditions. Consumer loans have grown recently, particularly for mortgages, amid falling interest rates and macroprudential measures. Nevertheless, due to global and geopolitical spillovers into domestic financial markets, commercial loans have yet to pick up robustly.

14. Long-term interest rates are currently on the rise across advanced economies, while projections for policy rates are revised upwards. The high likelihood of a Fed rate hike in December and the increased global uncertainty driven by the US presidential election send emerging financial markets into turbulence, inducing portfolio outflows. The negative impact of all these developments on lending standards is partly counterbalanced by liquidity measures, macroprudential policies and other incentives. Should financial conditions tighten more than expected, the CBRT will continue to use required reserves and other liquidity tools to support markets.

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 modestly over the upcoming period. The CBRT will continue

to monitor how developments in economic activity would affect price stability and financial stability. The Committee stated that adopting structural reforms may boost the economy's growth potential to a large extent.

16. The slower-than-expected economic recovery remains a downside risk to inflation, while exchange rate movements driven by heightened global uncertainty and volatility pose an upside risk to the inflation outlook.

17. The Committee decided to implement monetary tightening to contain the adverse impact of exchange rate developments on expectations and the pricing behavior. Moreover, this decision is expected to have more profound effects through supportive measures for the currency market. Accordingly, the Committee decided to provide repayment flexibility for export rediscount credits and to reduce the quantity of foreign-exchange required reserves.

18. In the upcoming period, monetary policy decisions will depend on the inflation outlook. The CBRT will maintain its cautious stance by taking into account the developments in inflation expectations, the pricing behavior and other factors affecting inflation.

19. The Committee 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.

20. 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.

21. 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.