TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 19 January 2016

Inflation Developments

1. In December, consumer prices edged up by 0.21 percent, and annual inflation rose by 0.71 points to 8.81 percent. This rise in inflation is attributed to the increase in unprocessed food prices and the base effect in energy prices. Core goods inflation continued to rise, and services inflation maintained its high level. Thus, annual inflation of core indicators recorded an increase, while its underlying trend improved slightly.
2. Annual inflation in food and non-alcoholic beverages rose by 1.35 points to 10.87 percent. This was driven by the rising prices of vegetables, and the annual rate of price increases reached 23.32 percent in this sub-group. Thus, unprocessed food inflation climbed to 13.83 percent, maintaining its high course of the last two years. On the processed food front, annual inflation increased to 8.33 percent due particularly to the price developments in oils and bread-cereals groups. Leading indicators for January suggest a persisting high course in food inflation.
3. On the energy front, despite a monthly decline by 0.22 percent in prices, annual inflation climbed to 2.96 percent due to the base effect in December. In January, the fall in oil prices notwithstanding, energy inflation is expected to increase further owing both to the low base in 2015 and the adjustment in electricity prices. In addition to the adjustment in electricity prices, adjustments introduced to some items with administered prices like tobacco and alcoholic drinks in early January will have a direct effect on inflation close to 0.7 point.
4. Prices of services increased by 0.22 percent, and annual services inflation slightly increased to 8.85 percent in the last month of the year. Thus, prices of services claimed the highest year-end increase since 2008. Food prices affected services inflation adversely through the catering services channel across the year, leading the restaurants-hotels group to register the highest increase, 13.23 percent, within the sub-groups. Meanwhile, the cumulative depreciation in the exchange rate coupled with the course of the headline inflation and the effects of wage developments stood

out as other factors for the high course of services inflation. On the other hand, slowing oil prices curbed services inflation through transport services.

5. Annual core goods inflation rose by 0.61 points to 10.22 percent in December. Annual inflation followed a flat course in durable goods, but recorded increases in other sub-groups. The cumulative depreciation in the Turkish lira continued to affect core goods, albeit with some slowdown. Clothing inflation remained on the rise, and annual inflation in this group rose by around 4.7 points to 9 percent in the last three-month-period. Seasonally-adjusted data indicated a decrease in the underlying trend of core goods inflation in December.

6. In sum, international energy prices continue to affect inflation favorably. On the other hand, other cost factors limit the improvement in the core inflation trend.

Factors Affecting Inflation

7. Industrial production recorded a month-on-month decline in November, yet the October-November average of the index stood above the third-quarter level. Among the BTS order indicators of the last three months, the domestic market orders registered a recovery, while the export orders declined. The Headline PMI and PMI production indices recorded an increase in December, following the increase in November, and remained above the stationary level. Despite the decline in December, consumer confidence indices stood above the level in October. The investor confidence also increased moderately in December. Against this background, industrial production is expected to register an increase on a monthly basis in December.

8. Data on the expenditure side suggest a milder course of private demand growth in the last quarter of 2015 relative to the third quarter. In the October-November period, production and imports of consumption goods registered a decline compared to the average of the previous quarter. Sales of white goods and automobiles trended downwards as well. Among indicators of investment, production of capital goods increased further in the October-November period, yet the imports receded. Manufacture of non-metallic mineral products and sales of heavy commercial vehicles, which are among the indicators for construction investment, registered a decline.

9. Favorable developments in the terms of trade accompanied by the moderate course of consumer loans support the recovery in the current account balance. Demand from the European Union economies continues to support exports, despite elevated geopolitical risks in other export markets. The trend of recovery in the European economy, which is a significant trading partner of Turkey, continued in the last quarter of 2015. In addition to the recovery trend in the Euro area, high market-shifting flexibility supports exports. Accordingly, improvement in the current account balance is expected to continue with the support of increased demand from the EU

countries, low course of commodity prices, and ongoing macroprudential policy measures.

10. In October 2015, unemployment rates registered a month-on-month increase. Labor force in non-farm sectors grew more than employment in this period. Industrial employment increased, while construction employment remained unchanged. Services employment, on the other hand, displayed a slight decline. Industrial production and survey indicators signal an increase in employment in the upcoming period. Manufacture of non-metallic mineral products hints at no additional revival in the construction sector. In the services sector, employment data in sub-sectors follow a fluctuating course. Accordingly, unemployment rates in the last quarter are expected to remain close to those of the third quarter.

11. To sum up, recent indicators suggest that growth in economic activity will continue in the last quarter of 2015, albeit at a slower pace. Despite the downside risk due to geopolitical developments, the recovery in the European economies continues to positively contribute to external demand. In the upcoming period, domestic demand is likely to be supported by the income channel through wage increases and the low course of oil prices, and by the confidence channel through waning domestic uncertainties. Hence, growth in economic activity is expected to continue.

Monetary Policy and Risks

12. The Monetary Policy Committee (the Committee) discussed the medium-term projections to be published in the January Inflation Report. Inflation in the last quarter of 2015 exceeded the projections of the October Inflation Report mainly due to unprocessed food prices. However, inflation excluding unprocessed food and tobacco was close to the October forecast in this period. Core inflation remained high due to the lagged effects of the cumulative depreciation in the Turkish lira, yet the ongoing fall in import prices in the fourth quarter limited the rise in CPI inflation. Evaluating assumptions underlying the inflation forecasts and the course of exogenous variables, an upward revision was made to the end-2016 inflation forecast, in consideration of the effects of the revisions in the Turkish lira-denominated import and oil prices, administered price adjustments announced in January and minimum wage arrangements.

13. Energy price developments continue to affect inflation favorably, while other cost factors limit the improvement in the core inflation trend. Food prices remain volatile due mainly to the unprocessed food group. Lagged effects of the depreciation in the Turkish lira are evident particularly on the core goods inflation. Moreover, as the minimum-wage adjustment passes through to overall wages, cost and demand pressures on inflation stemming from wages are likely to increase in the upcoming period. Accordingly, core inflation indicators are expected to remain high for a while. The effect of the above-target inflation on expectations and the acceleration in wage increases require the pricing behavior regarding the overall economy to be monitored closely. In this respect, considering the impact of wage developments and

the uncertainties in global markets on inflation expectations and pricing behavior, and taking into account the volatility in energy and unprocessed food prices, the Committee stated that the tight liquidity stance will be maintained as long as deemed necessary. 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.

14. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. The recent growth trend of loans reveals that both consumer and commercial loans remained below historical averages; consumer loans throughout 2015, commercial loans only in the second half of the year. Recent arrangements in risk weights and minimum wages are considered to boost loan growth through the loan supply and household income channels. On the other hand, the ongoing tightness in financial conditions is likely to keep the annual loan growth rates at reasonable levels. 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.

15. In the upcoming period, it is envisaged that the domestic demand will provide a slightly larger contribution to growth and the rising demand from the European Union countries will continue to improve exports. The recovery in the investor and consumer confidence led by waning domestic uncertainties, the room for spending amid the fall in oil prices and the effects of the recent wage developments on the purchasing power are projected to boost domestic demand. Persisting global volatilities and the tightness in financial conditions stand out as the factors that limit the domestic demand increase. On the foreign demand front, geopolitical developments pose a downside risk, yet the trend of rebound in the European economy coupled with the market-shifting flexibility of our exports cap this risk. In fact, exports towards the European Union countries have recently recorded a remarkable acceleration. Moreover, improvements in the terms of trade mainly led by the sharp fall in commodity prices, accompanied by the sluggish course of consumer loans support the improvement in the current account balance. Accordingly, the current account deficit is expected to decline further in the upcoming period.

16. Uncertainties surrounding global monetary policies and concerns over global growth cause financial markets to remain volatile. Thus, portfolio flows to emerging economies and risk indicators follow a highly volatile pattern. Exchange rates also display a quite fluctuating course. The Committee believes that the policy tools placed in the road map announced in August 2015 strengthen the resilience of the economy against global shocks.

17. In the upcoming period, both global and domestic volatilities will be monitored closely and required measures will continue to be taken. In this context, related departments presented information to the Committee on the foreign exchange liquidity instruments and methods that have been used since 18 August 2015 and that may be used in the upcoming periods and their effects.
18. In case the decline in loan growth rates becomes permanent and exchange rates continue to face upward pressure, the Committee, while preserving the tight monetary policy stance, may take measures to support the Turkish lira and loan growth by reconsidering the funding conditions for the use of foreign currency denominated collateral.
19. In this respect, the Committee stated that the policy stance will remain tight against the inflation outlook, stabilizing for the FX liquidity and supportive of the financial stability.
20. The Committee stated that the wide interest rate corridor has contributed to containing exchange rate volatility in times of heightened global volatility. The need for such an instrument would be reduced, should the decline in global volatility prove persistent. Another factor reducing the need for a wide interest rate corridor is the effective use of policy instruments laid out in the road map published in August. Excessive fluctuations both in exchange rates and loans have waned owing to the launch and effective use of these instruments. The Committee's assessment still prevails that the monetary policy may be implemented within a narrower and more standard interest rate corridor, should global volatilities see a permanent decline or the policy tools specified in the August road map permanently cap the effects of the global volatility on the Turkish economy.
21. 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.
22. 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.