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Summary of the Monetary Policy Committee Meeting

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Inflation Developments

1. In September, consumer prices increased by 0.14 percent and annual inflation declined to 8.86 percent. The fall in annual inflation was mainly attributed to the positive outlook on core goods and energy while the contribution of food to annual inflation remained high. For the underlying inflation trend, the improvement in the core goods continues to some extent whereas the services category remains on the rise.

2. Annual food inflation fell to 13.95 percent. In September, annual inflation dropped in both unprocessed and processed food but remained elevated due to adverse weather conditions and the cumulative effects of exchange rates. However, indicators for October point to some decline in annual unprocessed food inflation.

3. Falling to 1.38 percent in September, annual energy inflation contribute favorably to consumer inflation. Having decreased due to the weakening global demand, international oil prices are expected to continue to support this outlook. Yet, the October adjustments on natural gas and electricity tariffs are likely to drive energy prices significantly higher. These hikes are forecasted to add about 0.4 percentage points to annual consumer inflation.

4. Prices of services rose by 0.9 percent in September and annual services inflation remained constant around 8.96 percent. In this period, restaurants and hotels inflation maintained its high level with 14.43 percent, while transport and rent inflation maintained their upward trend that has been accelerating in recent months. Annual core goods inflation dropped to 9.42 percent in this period. Annual inflation continued to fall in durable goods but rose further, albeit more slowly, in core goods

excluding durables and clothing, which are affected by the exchange rate developments with a further lag. In line with the outlook on prices of services and core goods, underlying core inflation indicators continued to improve.

5. In sum, elevated food prices delay the improvement in the inflation outlook, yet falling commodity, especially oil, prices, are expected to support disinflation foreseen for the next year.

Factors Affecting Inflation

6. Data for the third-quarter of 2014 show a moderate quarter-on-quarter increase in economic activity. On the production side, the industrial production index decreased by 1.4 percent in August after growing by 1.9 percent in July. Thus, during July-August, production rose by 1.1 percent quarter-on-quarter. With the support of exports, this outlook is expected to be preserved in September as well.

7. Data on the expenditure side point to a moderate recovery in domestic private demand for the third quarter after the first-half decline. During July-August, the production of durable and nondurable consumer goods and imports of total consumer goods recorded increases. Similarly, the sales of automobiles and home appliances have picked up on the back of more favorable financial conditions. Among indicators for machinery-equipment investments, the production of investment goods excluding transport rose during July-August while their imports decreased. Meanwhile, the production of minerals, an indicator for construction investments, declined whereas their imports continued to rise. Given the fall in construction employment, it is assessed that private construction investments have slowed in the third quarter. Thus, private consumer spending is expected to rebound quarter-on-quarter whereas private investment demand may continue its weak course in the third quarter. On the other hand, data on third-quarter budget spending indicate that public demand might support growth in the third quarter.

8. In August, the non-gold import index nearly flattened out month-on-month while the non-gold export index was down by 7.9 percent due to geopolitical tensions and the automotive industry's August holiday scheme. Indicators for September point to a monthly fall in non-gold imports and to a rise in non-gold exports due to increased exports to Iraq and the pickup in the automotive industry compensating for the August decline. Hence, non-gold imports may post a slight quarterly increase in the third quarter of the year, whereas non-gold exports will remain flat. Moreover, it is assessed that weak global demand and geopolitical risks might continue to limit the contribution of net exports to growth in the final quarter.

9. In July, total and nonfarm unemployment rates were higher than in the previous period in seasonally adjusted terms. The rise in unemployment was largely due to weak outlook in non-farm employment. Yet the increase in labor force participation is marked. In this period, the downtrend in construction employment halted, while losses in industrial employment persisted. Meanwhile, services employment continued to support nonfarm employment. Leading indicators for the third quarter fail to signal a positive outlook for nonfarm employment. The low levels of investment tendency and the moderate growth in industrial production suggest that a recovery in the labor market may take some time.

10. To sum up, third-quarter data indicate that private domestic demand recovered modestly. As suggested by surveys, the moderate recovery of domestic demand may continue into the final quarter. However, a possible slowdown across European economies and geopolitical tensions may cause external demand to weaken. Therefore, economic activity is expected to grow moderately and gradually in the second half of the year. On the other hand, uncertainty over global monetary policies, the recent increase of volatility in financial markets and the weak consumer and investor confidence pose downside risks on growth. Thus, demand conditions are expected to limit the upside pressures on inflation while domestic demand developments will support the improvement in current account balance.

Monetary Policy and Risks

11. The Committee assessed the medium-term forecasts projected to be included in the October Inflation Report. Due to the negative supply-side developments, food prices remained elevated in the third quarter of 2014, which led the annual consumer inflation to exceed the forecasts presented in July Inflation Report. Upon the evaluation of assumptions underlying inflation forecasts and external conditions, given the developments in import and oil prices, food prices, energy price adjustments, output gap and the underlying inflation trend, year-end inflation forecasts for 2014 and 2015 were revised upwards.

12. Global financial markets have recently followed a volatile course. While, the Fed terminated its quantitative easing program, the timing and magnitude of the policy rate increase remained uncertain. The ECB reduced policy rates against the risks of economic slowdown and deflation and announced a new quantitative easing program through the purchase of covered bonds and asset-backed securities. Persisting uncertainties regarding global monetary policies and the downturn in global economic activity may lead to volatility in capital inflows towards emerging economies as well as their risk indicators. The Committee stated that the reduction in

interest rates on the foreign exchange deposits that banks can borrow from the CBRT within their borrowing limits in the Foreign Exchange Deposit Market would support balanced growth and continuity of capital inflows towards Turkey during the normalization of global monetary policies. In addition, it is important to further strengthen the current healthy structure of the banking sector. Accordingly, the Committee stated that introducing an additional support to the core liabilities of financial institutions through remuneration of required reserves which are held in Turkish lira would spur balanced growth and domestic savings.

13. Elevated food prices delay the improvement in the inflation outlook. Unfavorable developments in food prices were mainly driven by supply conditions. Should supply conditions make no additional negative contribution in 2015, and food inflation near its averages of past years, there will be a considerable room for decline in inflation through this channel. Due to the recently-weakening global demand, falling commodity prices, oil in particular, are expected to support the disinflation process projected for 2015. In contrast to these positive developments in the inflation outlook, the current elevated levels of inflation affect the medium-term expectations adversely and boost risks related to pricing behavior. The Committee will closely monitor inflation expectations, pricing behavior and other factors that affect inflation, and maintain a tight monetary policy stance by keeping a flat yield curve until there is a significant improvement in the inflation outlook.

14. Growth rates and composition of loans evolve in the desired direction, owing to the tight monetary policy stance and macroprudential measures. Consumer loan growth followed a weak course, while commercial loan growth was relatively more robust. This favorable outlook of loans both contributes to disinflation and support rebalancing of the current account. Additional tightening measures will be taken should credit growth accelerate in a way that poses upside risks to inflation and aggravates financial risks by distorting the rebalancing process.

15. Recently-released data point to a deceleration in economic activity. An overall slowdown in growth in the global economy has been observed in the second and third quarters of 2014. Languishing external demand due to halting growth in the European countries, the largest export market of Turkey, besides geopolitical developments in neighboring countries limit the growth of exports. Falling commodity prices due to the weak global demand are expected to restrict growth in imports and improve the current account balance. Meanwhile, on account of the lingering volatility in financial markets and the sluggish course of confidence indices, private sector final demand does not exhibit a steady recovery. Therefore, it is expected that the projected recovery in economic activity will be gradual and

aggregate demand developments will support the disinflation process. In the case of an additional slowdown in external demand and a sizeable decline in global growth rates, the decrease in commodity prices will pull inflation down. Nevertheless, domestic economic activity may witness notable adverse effects at the same time. Under such circumstances, the Committee will employ policy tools to support the economy.

16. Macroprudential measures taken at the beginning of the year coupled with the tight monetary stance have a favorable effect on the core inflation trend. Having significantly increased in early 2014, trend of core inflation indicators H and I have recently improved and most of the rise in inflation trend was taken back by the third quarter. Accordingly, the adverse impact of exchange rate developments on annual inflation is tapering off. This channel is assessed to provide inflation with a considerable room for decline in 2015. However, second-round effects and inflation expectations need to be closely monitored. In the event that additional deteriorations occur in the medium-term inflation outlook, liquidity and monetary policies would be tightened.

17. The Committee closely monitors developments on the fiscal policy and tax adjustments with regard to their effects on the inflation outlook. The baseline monetary stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes on administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

18. Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improving social welfare by keeping interest rates of long-term government securities at low levels. In this respect, implementing the structural reforms required by the Medium Term Program remains to be of utmost importance.

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