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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 14 September 2017

Inflation Developments

1. In August, consumer prices were up 0.52 percent and annual inflation rose by 0.89 points to 10.68 percent. Inflation recorded a spike in food and energy and remained elevated in services. Clothing and durable goods sent inflation soaring across core goods, pushing the annual inflation and the underlying trend of core indicators higher.

2. Annual inflation in food and nonalcoholic beverages increased by 1.9 points to 11.97 percent in August due to both a negative base effect from unprocessed food prices and widespread upsurges of processed food prices. Leading indicators for September signal that annual food inflation will remain on the rise mainly due to the base effect from unprocessed food. Energy prices jumped by 2.03 percent in August amid price developments in oil and other inputs. Thus, having been on an upward track for the last two months, annual energy inflation amounted to 10.54 percent.

3. Prices of services rose by 0.73 percent while annual services inflation remained high at a virtually unchanged 9.40 percent in August. In this period, inflation was higher across catering and accommodation services due to rising food and beverage prices as well as the recovering tourism. Other drivers of high services inflation include soaring costs and indexation to headline inflation. In fact, prices of educational services, which are largely inflation-indexed, surged by 2.79 percent, driving annual inflation up to 10.30 percent in this subcategory.

4. Annual core goods inflation increased by 1.22 points to 11.08 percent in August. Clothing and durable goods prices drove annual inflation higher amid the Turkish lira’s slide against the euro and the strong economic activity. With the methodology change for clothing factored in as well, inflation seems to be on the rise for the last two months. Among durable goods, price hikes were more prevalent in furniture, automobiles and home appliances, yet monthly price increases continued to slow across core goods excluding clothing and durable goods. Indicators for September hint at continued uptrend in core goods inflation, albeit mainly due to the methodology change in the weight system for the clothing category.

5. In sum, current elevated levels of inflation and developments in core inflation indicators pose risks to the pricing behavior.

Factors Affecting Inflation

6. Gross Domestic Product (GDP) grew annually 5.1 percent and quarterly 2.1 percent in the second quarter of 2017. Economic activity was thus stronger than in the first quarter. The upward revisions to the data of previous periods were also considered as signs of an even stronger economic activity leading to the conclusion that the disinflationary contribution of demand conditions has reduced significantly as of the second quarter. The main driver of quarterly growth in this period was domestic demand, particularly construction investments and private consumption. Net exports made a negative contribution to quarterly growth due to the domestic demand-led upswing in imports and weaker exports, yet continued to boost annual growth.

7. Leading indicators suggest that economic activity remained robust in the third quarter. July's industrial production data and the PMI data for August signal stronger growth in the third quarter compared to the previous one. Not only the manufacturing industry, but also services, retail trade and construction saw strengthening activity recently. Accordingly, economic recovery appears to be more widespread across sectors.

8. A similar outlook is also evident in demand indicators. The consumer demand for categories subject to incentives remains robust while investments edged up in the second quarter after a subdued first quarter. Domestic demand is likely to make more contribution to growth in the third quarter. Given the strengthening economy as well as the calendar and base effects, the Committee expects a sizable annual growth for the third quarter.

9. Domestic demand keeps recovering while net external demand spurs growth thanks to increases in exports of goods that spill over into a wide range of sectors. The improving growth outlook across the globe, particularly for the EU and Turkey's flexibility to shift markets abroad continue to stimulate exports. Increases in exports of goods slow down the deterioration of the current account deficit and help improve core current account deficit indicators. In addition to the expected partial recovery in tourism, the uptrend in exports of goods is envisaged to contribute further to the current account balance.

10. The uptick in the labor market, which started in February and March, continued in June period. In this period, nonfarm employment was up on account of services. Leading indicators signal further gradual decreases in unemployment rates over the upcoming period amid economic recovery.

11. In short, recently released data indicate that the recovery in economic activity has gained strength. Domestic demand conditions keep improving and demand from the European Union economies continues to contribute positively to exports. The

Committee assesses that the implementation of the structural reforms would contribute to potential growth significantly.

Monetary Policy and Risks

12. Global economic activity has recently settled on a trend of recovery due both to advanced and emerging economies. The optimistic outlook in the consumer and the real sector confidence indices, ongoing favorable conditions in global financing and stabilizing commodity prices also underpin the positive outlook in global economic activity. Leading indicators for the third quarter hint at a better growth performance than the second quarter, which lead to upward revisions in the year-end growth projections for 2017. While communications by advanced economy central banks regarding the normalization of monetary policies occasionally cause short-term market volatility, the monetary policy normalization process has remained moderate because of still low global inflation rates. The elevated risk appetite and the subsided volatility in global financial markets along with favorable figures regarding global growth, keep portfolio inflows to emerging economies brisk including Turkey.

13. Despite the current favorable outlook in global economic activity, downside risks to global economy reside as well. In particular, should the normalization process of the Fed's policy-rate increase and the balance sheet downsizing prove faster than expected, the high risk appetite and low volatility cycle in financial markets may reverse. That may generate fluctuations in prices of securities in advanced economies and weaken the growth trend. Moreover, fading risk appetite also led by geopolitical developments may cause fluctuations in portfolio flows to emerging economies as well.

14. In line with the upbeat mood in global financial markets, domestic financial conditions also continued to be supportive of economic activity in the third quarter. This was driven by macroprudential policies, public measures and incentives, as well as the credits secured by the Credit Guarantee Fund (CGF), which improved overall credit conditions. As the upper limit defined in credits secured by the CGF becomes near and the supply-side effects have recently stepped in the banking sector, credit growth is balancing at milder levels, approaching past averages in the third quarter. The strong acceleration in credits in the first half of the year is monitored closely with regard to the extent of its impact on the aggregate demand and economic activity.

15. Recently-released indicators confirm the previous view that downside risks to economic activity have abated and the economic recovery will prove more robust starting from the second quarter of the year. Third-quarter indicators reveal an ongoing robust economic activity. Exports remain buoyant despite some deceleration, and investments signal for recovery on the back of the sustained improvement in domestic demand. Annual growth in the third quarter is likely to prove quite high due to the calendar and base effects. The remainder of the year is

anticipated to witness a milder trend in economic activity due to the fading effects of the CGF support on growth and the withdrawal of the tax incentives on consumption expenditures.

16. Assessing the data on economic activity and the labor market jointly suggests a subsided disinflationary support from demand conditions in some sectors. Base effects in the food group, temporary tax reductions in white goods and the furniture sector that will be taken back in October as well as the methodological changes stand out as factors that will lead to fluctuations in inflation in the short term and temporary increases in core inflation. The inflation outlook is projected to improve gradually starting from the last months of the year, yet the pace and quality of this improvement will be monitored closely.

17. Against this background, the Committee decided to maintain the tight stance of monetary policy in its September meeting and kept the Late Liquidity Window lending rate constant at 12.25 percent. The CBRT will continue to use all available instruments in pursuit of the price stability objective. Tight stance in monetary policy will be maintained until inflation outlook displays a significant improvement. The CBRT formulates monetary policy by taking the medium-term inflation into account, thus focusing on the developments in underlying inflation rather than the anticipated fluctuations driven by the base effects during the course of the year. Inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and further monetary tightening will be delivered if needed.

18. Developments in fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance for the upcoming period is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices and taxes. 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.

19. In recent years, sustained fiscal discipline has been one of key factors in lowering the sensitivity of the Turkish economy against external shocks. The room provided by fiscal discipline facilitated the implementation of expansionary fiscal policy. Structural measures to provide room for counter-cyclical fiscal policies will enhance the coordination of monetary and fiscal policy, and improve macroeconomic stability.